CORPORATE GOVERNANCE AND ETHICS:

CASE STUDIES

Edited by Prof Mak Yuen Teen

2024 SERIES:
VOLUME 3

NUS National University of Singapore

Centre for Investor Protection
NUS Business School

CORPORATE GOVERNANCE AND ETHICS: CASE STUDIES

2024 Series: Volume 3

ASIA-PACIFIC AND GLOBAL CASES

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ISBN: 978-981-94-0695-1

Title: Corporate Governance and Ethics: Case Studies, 2024 Series, Volume 3

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PREFACE

This is the third volume of the 2024 series of Corporate Governance and Ethics: Case Studies, the inaugural publication from the newly-established Centre for Investor Protection at the NUS Business School.

The cases are written from public information to facilitate discussion and for use in courses and programs for undergraduates, graduates, executives, directors, and other stakeholders. While the cases are selected for their relevance to issues relating to ethics, corporate governance, and investor protection, they often raise many other business issues, such as business models, finance, accounting, and sustainability. I personally reviewed and did the final editing for every case.

These cases are available for use free of charge. We only request that those using the cases write to me at bizmakyt@nus.edu.sg letting me know which cases they are using and for what courses and programs, and to acknowledge the source of these cases.

This volume includes five cases involving companies outside the Asia-Pacific.

Three of the cases involve bank collapses. Poor risk management is a common issue in these cases. There is the Credit Suisse and the government-directed rescue by UBS, and the collapse of First Republic Bank and Silicon Valley Bank in the US. Arguably the biggest scandal over the past few years was the collapse of FTX, the world's second largest cryptocurrency exchange.

The case on FTX involves issues such as corporate governance of crypto firms, experience and competencies of management, ethics, risk management, investors' due diligence, external audits, cross-border regulatory issues, and regulation of crypto firms. Major issues in the case on Disney include as CEO succession, the role of current CEO in choosing a successor, the continuing involvement of former CEOs in a company, and the role of executive chairman.

I would like to acknowledge the students in the Corporate Governance and Risk Management and Governance, Risk Management and Sustainability courses who worked on the original cases as part of their course requirements. Their names are listed in each case. I would also like to thank the students who helped with checking the accuracy and editing the cases for the three volumes. Their names are listed in the Preface for Volume 1. But most of all, I would like to thank my editorial assistant, Koh Yan Qi, who was excellent in not only checking and editing a few of the cases, but also doing further reviews and editing of all the cases edited by the other students.

This publication and the establishment of the Centre for Investor Protection would not be possible without the generous donation from a donor who believes in the importance of corporate governance and investor protection for a robust capital market. I am deeply grateful to this donor.

Mak Yuen Teen, PhD
Professor (Practice) of Accounting
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CREDIT SUISSE: UBS TO THE RESCUE

Case overview

In a dramatic turn of events in mid-March 2023, Swiss banking giant UBS Group AG (UBS) undertook a historic acquisition, purchasing its long-time rival Credit Suisse Group AG (Credit Suisse) for CHF3 billion. The move was not merely a strategic business decision, but a critical intervention aimed at averting the collapse of Credit Suisse and stabilising the global banking system.

Credit Suisse, with a legacy spanning over 150 years, had played a pivotal role in shaping Switzerland's financial landscape and establishing the nation as a key player in international finance. However, since 2020, the venerable institution has found itself mired in a series of scandals and financial setbacks that tarnished its once-illustrious reputation. The final blow came when Saudi National Bank refused to extend further financial support, sparking a chain of events that led to Credit Suisse's collapse.

The objective of this case study is to facilitate a discussion of issues such as contributing factors to the collapse of Credit Suisse; risk management; impact on stakeholders; the Swiss government's intervention; Credit Suisse's board structure; and Swiss corporate governance and banking regulations.

Credit Suisse's birth

Credit Suisse Group AG (Credit Suisse) was founded in 1856 by a young Zurich politician, Alfred Escher, in Switzerland. The initial purpose of "Schweizerische Kreditanstalt", which was the bank's original name upon incorporation, was to finance the expansion of Switzerland's railway system. Due to the growth of various industries in Switzerland and the continued expansion of the railway, Credit Suisse was provided with further opportunities to develop and prosper. At the end of the 1870 Franco-Prussian War, Credit Suisse became the largest bank in Switzerland and opened its first branch outside of Zurich in 1905, in Basel.

This case study was originally prepared by Alicia Lim Qian Hui, Isaiah Goh Weng Keong, Jonathan Low Jun Jie, Srinivasan Sowmiya Ramyasree, Tvaritha Nirmalkrishnan, and Zhu Jia Hui, Grace. It has been edited by Alden Wordsworth Ng and Koh Yan Qi, under the supervision of Professor Mak Yuen Teen, with additional content added. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees.

Credit Suisse had a significant global presence, with operations in more than 50 countries around the world. The bank's core services, which catered to both individuals and institutional clients, included private banking, wealth management, investment banking, asset management and retail banking.

As of 31 December 2022, the major shareholders of Credit Suisse were Saudi National Bank (9.88%), Qatar Holding LLC (5.03%), The Olayan Group (4.93%) and BlackRock Inc. (4.07%).[1]

Recent performance

Figure 1 shows selected key indicators for Credit Suisse from 2018 to 2022.[2]

Figure 1: Selected Credit Suisse statements of operations[3]

CHF (Million)	2018	2019	2020	2021	2022
Net Income/(Loss)	2,011	3,425	2,666	(1,626)	(7,306)
Customer Deposits	365,263	384,950	392,039	303,841	234,554
Tier 1 Capital	48,231	54,024	55,659	59,110	54,813
Tier 1 Capital Ratio	16.9	18.6	20.2	22.1	22.0
Major Litigation Provisions	(244)	(389)	(988)	(1,221)	(1,299)

Source: Credit Suisse. (2022). Credit Suisse annual report 2022.

Customer deposits represent the most stable and typically cheapest form of funding for a bank. They are the basic building blocks of a bank's funding and liquidity profile.[4]

Tier 1 capital is the core measure of a bank's financial strength. It indicates the core capital in a bank's reserves used to fund its business activities and includes common stock, disclosed reserves, and certain other assets. Under the Basel III standards, banks must maintain the equivalent of 6% of their risk-weighted assets (RWA) in Tier 1 capital. This requirement allows banks to absorb unexpected losses without threatening the stability of the institution and to continue operating as a going concern.[5]

The Tier 1 Capital Ratio is a financial institution's core capital divided by its RWA. Regulators use it to ensure financial stability in the system by requiring financial institutions to have a ratio above a certain threshold. A higher ratio implies more safety.[6]

Major Litigation Provisions represent loss contingency litigation provisions for proceedings in which losses, additional losses, or ranges of loss are probable and reasonably estimable, as stated in Credit Suisse annual reports.[7]

Escalating crisis

From 2019 to 2022, the bank found itself in a string of high-profile scandals, ranging from allegations of fraud to money laundering, resulting in a surge in litigation provisions from CHF389 million to CHF1.299 billion and substantial financial losses. This turbulent period witnessed a sharp decline in net income from a peak of CHF3.4 billion in 2019 to a staggering CHF7.3 billion loss in 2022.[8]

These scandals eroded customer trust, evidenced by a sharp decrease in deposits during this period. As Credit Suisse found itself mired in legal battles and a crisis of confidence, a series of events eventually led to the collapse of Credit Suisse.

Rapid descent

In March 2023, Credit Suisse faced a series of critical challenges that led to its eventual downfall. It began with a delay in its annual report due to a last-minute call from the US Securities and Exchange Commission (SEC)[9] regarding a "technical assessment of previously disclosed revisions to the consolidated cash flow statements and related controls in 2019 and 2020".[10] This was followed by the admission of "certain material weaknesses in (their) internal control over financial reporting",[11] related to a "failure to design and maintain an effective risk assessment process to identify and analyse the risk of material misstatements"[12] and various flaws in internal control and communication.[13] This sent shockwaves through the already fragile markets, reeling from the collapse of American regional lenders, Silicon Valley Bank and Signature Bank, leading to a 5% drop in Credit Suisse's share price at market opening.

The crisis deepened with the withdrawal of support from its largest shareholder, the Saudi National Bank. In an interview with CNN, the Saudi National Bank, represented by Ammar Al Khudairy (Al Khudairy), the bank's Chairman, categorically ruled out any further equity injection if a call for additional funds came from Credit Suisse stating: "The answer is absolutely not, for many reasons outside the simplest reason, which is regulatory and statutory."[14]

This triggered a panic sale that saw Credit Suisse shares plummet by 24% in a single day.[15] In a desperate bid to stabilise markets, the Swiss National Bank (SNB) threw a CHF50 billion liquidity lifeline,[16] but this proved insufficient to stem the exodus of clients, with an average of US$10 billion daily outflows to cap the week.[17]

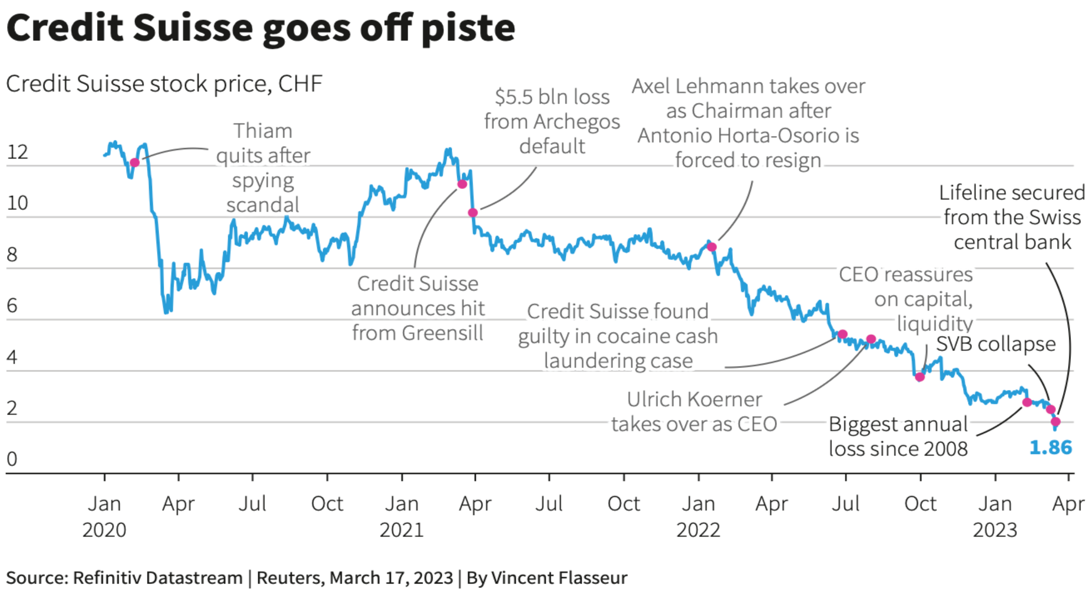
Just five days after the admission of "material weaknesses", Credit Suisse's 167 years' history came to a tragic end on 19 March 2023, with the Swiss Financial Market Supervisory Authority (FINMA) brokering a takeover deal by UBS Group AG (UBS) for CHF3 billion in stock and assuming up to CHF5 billion in losses.[18]

The rapid collapse of Credit Suisse can be traced back to a series of scandals that eroded trust and confidence between 2020 and 2023. Poor risk management related to the high-profile failures of Credit Suisse clients - Archegos Capital Management (Archegos) and Greensill Capital - in 2021, saw Credit Suisse racked up a combined loss of US$15.5 billion.[19] Bribery by Credit Suisse's employees in the "Tuna Bond" scandal in Mozambique[20] along with the Bermuda fraud scandal relating to Credit Suisse's star banker, Patrice Lescaudron,[21] raised red flags about the lender's internal controls, corporate ethics, and culture.

Further tarnishing its already tainted reputation, Credit Suisse faced a guilty verdict in a money laundering scandal linked to a Bulgarian Cocaine ring,[22] along with a data leak that exposed accounts managed by Credit Suisse originating from individuals under sanctions, such as human rights abusers.[23] Post-merger, Credit Suisse was found to have violated a 2014 plea deal with the US authorities by continuing to assist ultra-wealthy Americans in evading taxes and concealing more than US$700 million from the government.[24]

As Figure 2 shows, each scandal contributed to a progressive decrease in Credit Suisse's share price.

Figure 2: Credit Suisse's stock price in relation to scandal events[25]



Source: Reuters. (2023, March 17) Credit Suisse goes of piste.

FINMA and SNB to the rescue

On 16 March 2023, headlines blared with alarming news: "Credit Suisse was so fragile that a blunt answer in a TV interview was enough to send it to ask the Swiss central bank for US$54 billion".[26] This followed the statement by the Chairman of Saudi National Bank. To address Credit Suisse's liquidity crisis, the SNB extended a substantial CHF50 billion lifeline.[27]

However, while this move provided a temporary financial cushion, the larger issue of trust remained unaddressed. The burning question was not about money but credibility – how could Credit Suisse regain the confidence of its shaken clients? Even with reassurances from the SNB and FINMA that Credit Suisse "meets the capital and liquidity requirements imposed on systemically important banks,"[28] investors remained cautious about the entire banking sector. This wariness was fuelled by the recent vulnerability exposed in the collapse of Silicon Valley Bank the prior week.

The government said that allowing Credit Suisse, one of the world's 30 most important banks, to fail would probably have triggered an international financial crisis.[29] On 19 March 2023, the SNB and Switzerland's financial regulator FINMA orchestrated a takeover by UBS. In an all-share transaction, UBS acquired Credit Suisse, valuing it at CHF3 billion, while also agreeing to absorb potential losses of up to CHF5 billion. Unfortunately, the burden of this merger fell squarely on the holders of Additional Tier 1 (AT1) bonds, who saw their high-risk bonds amounting to CHF16 billion completely wiped out.[30]

This acquisition was not subject to a shareholder vote, as per an agreement reached with Swiss authorities and regulatory bodies. Credit Suisse shareholders received a payout equivalent to CHF0.76 per share, a 59% decrease from the previous closing price and a stark drop from its share price at the time of former Chief Executive Officer (CEO) Tidjane Thiam's (Thiam) departure in February 2020. Thiam had led Credit Suisse since March 2015.[31] The Swiss Finance Minister said: "The primary goal of the Federal Council was to ensure the stability of the Swiss economy and the Swiss financial centre and to prevent an international financial crisis. Under the circumstances, it was […] the best possible choice, which also places the least burden on the state and the taxpayer".[32]

On 23 May 2023, the Swiss Finance Ministry issued an order to cancel outstanding bonus payments up to the end of 2022 for Credit Suisse's top three levels of management. Additionally, the bank was directed to explore the feasibility of clawing back bonuses that had already been disbursed. Governments rarely impose a complete halt to bonus pay-outs but the move was seen to be essential in response to the public backlash over bonus payments. The implementation of these measures was aligned with Swiss banking law, which authorises such actions related to bonuses for systemically important banks that have received state aid from federal funds.[33]

The Federal Council, the highest executive authority of the Swiss government, implemented a comprehensive set of measures that further facilitated UBS' takeover of Credit Suisse. Among the components of the package were a CHF9 billion federal loss protection guarantee for UBS and a CHF100 billion guarantee for the SNB to secure liquidity assistance loans.[34] With UBS as the surviving entity, this marked the conclusion of Credit Suisse's 167-year history.

Red flag risk governance?

Credit Suisse's risk management downfall did not occur due to a single trigger event but rather was the consequence of a gradual accumulation of issues over time. In 2015, Thiam introduced a strategy that shifted divisional powers and focused on new markets.[35] This initiative led to the departure of many top managers who did not support the new direction. Decision-making power was then reportedly delegated to individuals who supported the strategy, regardless of their expertise and ability to make prudent decisions for the bank.[36] Consequently, the relentless pursuit of profit and growth resulted in a gradual erosion of Credit Suisse's risk management practices, culminating in aggressive risk-taking, financial losses, and instances of misconduct. While the actual decline in Credit Suisse's share value were triggered by significant losses associated with the collapse of investment fund Archegos and Greensill Capital,[37] the bank's downfall has been attributed to numerous scandals over the years, including money laundering, corruption, tax evasion, and more which eroded shareholder trust over time.[38]

The Archegos risk management failure

Failure in risk management practices was seen as one of the most critical governance issues at Credit Suisse. The bank took on excessive risks that were inadequately managed or mitigated, as exemplified by the high-profile Archegos collapse.[39]

On 21 July 2023, the Prudential Regulation Authority (PRA), part of the Bank of England, imposed a fine of £87 million on Credit Suisse for significant risk management and governance failures between 1 January 2020 and 31 March 2021, related to its exposures to Archegos.[40] Additionally, a report issued by Credit Suisse following an independent external investigation by Paul, Weiss, Rifkind, Wharton & Garrison LLP into Archegos revealed that: "The Archegos default exposed several significant deficiencies in CS's risk culture, revealing a Prime Services business with a lackadaisical attitude towards risk and risk discipline; a lack of accountability for risk failures; risk systems that identified acute risks, which were systematically ignored by business and risk personnel; and a cultural unwillingness to engage in challenging discussions or to escalate matters posing grave economic and reputational risk."[41]

According to the PRA, Credit Suisse lacked a clear culture of risk ownership within its first and second lines of defence.[42] The Prime Service Risk function, which served as the first line within the Prime Service business, failed to challenge the business and effectively manage Archegos related risks. Meanwhile, Credit Risk Management (CRM), as the second line function responsible for independent oversight of credit risk management, failed to demonstrate sufficient ownership of risk management, particularly concerning transactions remotely booked into Credit Suisse.[43]

Moreover, senior management and senior individuals within Credit Swiss agreed to temporarily increase the Single Financial Transaction Quota (SFTQ) limit to US$900 million to prevent limit breaches related to Archegos' portfolio from being reported as breaches under the Risk Management Committee (RMC). The UK CRM also noted that at the time of the decision, Archegos' portfolio had already exceeded the US$900 million limit. There was no evidence that the negative factors identified by UK CRM during their analysis and discussion of the proposal were communicated to senior management responsible for Credit Suisse's risk function as part of the approval process for the bespoke appetite scenario. Senior management in Risk explained to the PRA that they approved the proposal based solely on the recommendation of UK CRM.[44]

> "Fundamentally, CS failed to effectively address a culture that encouraged aggressive risk-taking and injudicious cost-cutting, as well as a complex and silo-ed organisational structure that impeded the swift identification, understanding, and escalation of risk."
>
> – *Paul, Weiss, Rifkind, Wharton & Garrison LLP*[45]

Material weaknesses in internal control

In March 2023, Credit Suisse delayed the publication of its financial year (FY) 2022 annual report following a late call from the US Securities and Exchange Commission (SEC) with regards to a "technical assessment of previously disclosed revisions to the consolidated cash flow statements and related controls in the years ending 2019 and 2020."[46] Credit Suisse then issued a statement within the annual report acknowledging "material weaknesses" in its internal control over financial reporting. Such weaknesses could potentially result in misstatements of account balances or disclosures, leading to material misstatements in the bank's financial statements. The identified material weaknesses include "the failure to design and maintain an effective risk assessment process to identify and analyse the risk of material misstatements in its financial statements and the failure to design and maintain effective monitoring activities pertaining to various areas."[47]

Furthermore, during the audit of Credit Suisse's financial statements, PricewaterhouseCoopers (PwC) issued an adverse opinion on the effectiveness of Credit Suisse's internal controls over financial reporting.[48] As a result, the group's internal control, disclosure controls, and procedures were deemed to be ineffective. In response to these findings, Credit Suisse's management reportedly said it was developing a "remediation plan" aimed at strengthening the risk and control frameworks within the organisation.[49]

More governance crises…

Credit Suisse faced several compliance failures, including lapses in anti-money laundering controls and breaches of client confidentiality. Morningstar DBRS, which covers Credit Suisse stock, told CNBC that an episode of data leaks concerning the bank's client information which "showed that criminals, alleged human rights abusers and sanctioned individuals had been clients of the Swiss bank"[50] had "highlight[ed] additional risk management shortcomings at Credit Suisse, including anti-money laundering procedures and lack of internal controls and management accountability."[51]

The bank's downfall was also attributed to poor corporate ethics and a culture that prioritised short-term gains and aggressive risk-taking over long-term stability and compliance. Whistleblowers who revealed Credit Suisse's assistance to wealthy American families in evading taxes highlighted the constant pressure on bankers to retain and attract deposits. One whistleblower described a culture where bankers were expected to keep the assets of wealthy clients within the bank, even if it required unethical practices. Senior executives would publicly call out individual bankers at quarterly meetings by reading out their asset numbers. Another whistleblower explained that if a banker's number declined, "you'd get exposed in front of your colleagues." And as a result, he said, "there may come moments where people simply omit saying things." Accordingly, he concluded that: "'Don't Ask, Don't Tell' is maybe a good explanation to what happened".[52]

Credit Suisse pleaded guilty in 2014 to criminal charges for "knowingly and wilfully" helping thousands of US clients conceal their offshore assets and income from the Internal Revenue Services (IRS). It admitted at the time that it used sham entities, destroyed account records, and hand-delivered cash to American clients to evade detection by the IRS. As part of its plea deal, Credit Suisse agreed to crack down on US tax dodgers going forward. The bank also agreed to a host of reforms, including disclosing its cross-border activities and cooperating with authorities when they request information, among other things.[53]

However, subsequent to these events, the two whistleblowers mentioned above came forward to report that Credit Suisse had violated the agreement. This was corroborated by another report detailing ongoing and rampant abuse since the plea deal was reached. Individuals close to the report informed the press that: "Credit Suisse employees aided and abetted a major criminal tax evasion scheme," with the report discovering that Credit Suisse enabled as many as 25 American families to conceal fortunes totalling more than US$700 million in the bank in the years after Credit Suisse's plea agreement.[54]

Board structure

Switzerland's corporate governance practices stem from several sources, mainly the Swiss Code of Obligations. Additionally, the Federal Act on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading outlines a regulatory framework regarding stock exchanges and capital markets for Swiss companies. On the SIX Swiss Exchange, the Listing Rules are another set of regulations for listed companies. Despite being a non-binding framework, the Swiss Code of Best Practice for Corporate Governance is generally seen as the best practice for Swiss listed companies, and is predicated on a "comply-or-explain" approach.[55]

In accordance with Swiss law, Credit Suisse has a two-tier board structure, comprising a board of directors (BOD) and an executive board (EB). The BOD constitutes the upper tier, with primary responsibilities that include supervising and advising members of the EB, as well as ensuring strategic oversight of the company.[56] Members of the BOD are individually elected during the Annual General Meeting (AGM) by shareholders and must be re-elected annually.[57]

Under Swiss law, the BOD is not required to include independent directors (IDs), although it is recommended that a majority of its members be non-executive directors.[58] In FY2022, all 12 members of Credit Suisse's BOD were IDs, with details shown in Figure 3.

Figure 3: Credit Suisse's board of directors as of end of 2022[59]

Name	Age	Position	Areas of Expertise and Prior Roles
Alex P. Lehmann	63	Chairman	• Client-facing business; risk, legal and/or compliance; and government, regulatory and/or academia • Previously Group Chief Operating Officer of UBS and Group Chief Risk Officer of Zurich Insurance Group Ltd.
Christian Gellerstad	54	Board member	• Client-facing business; and investment management • Previously Chief Executive Officer of Pictet Group's Wealth Management, Equity Partner of Pictet Group, and emerging markets trader at Cargill International
Mirko Bianchi	60	Board member	• Finance and/or audit; and risk, legal and/or compliance • Previously Group Chief Financial Officer of UniCredit, Managing Director of UBS' Global Head of Ratings Advisory, and Director of Deutsch Bank AG's Debt Capital Markets
Iris Bohnet	56	Board member	• People, culture and/or compensation; ESG; and government, regulatory and/ or academia • An Albert Pratt Professor of Business and Government and Co-Director of the Women and Public Policy Program at Harvard Kennedy School since 2018

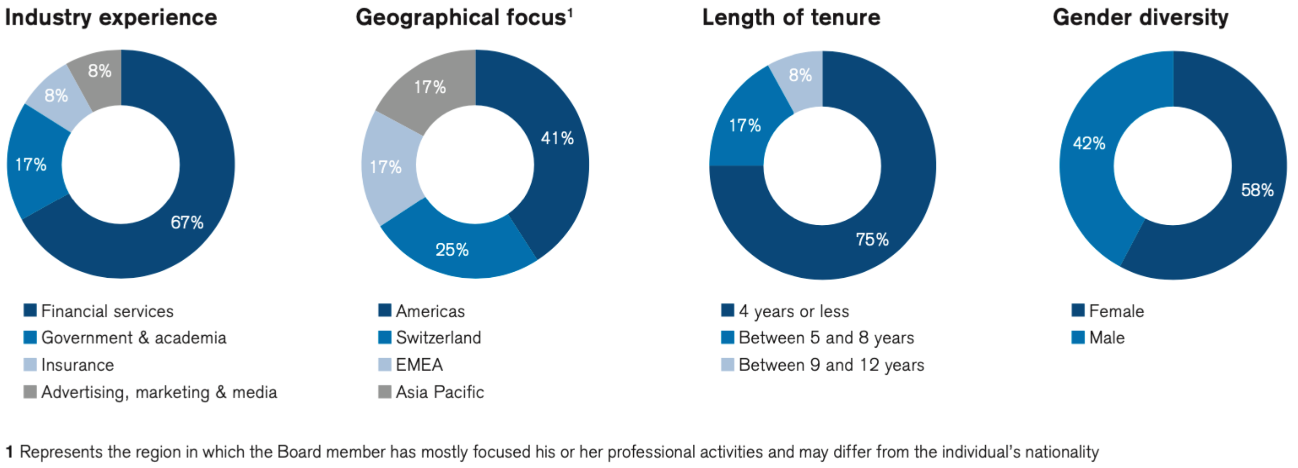
Name	Age	Position	Areas of Expertise and Prior Roles
Clare Brady	59	Board member	• Finance and/or audit; risk, legal and/or compliance; and government, regulatory and/or academia • Previously Managing Director, Group Audit, Asia Pacific Regional Head of Deutsch Bank AG and has experience working in many banks including International Monetary Fund, World Bank Group, Bank of England, Barclays Capital, and HSBC.
Keyu Jin	40	Board member	• Government, regulatory and/or academia • Previously a Visiting Professor of Economics in universities such as Tsinghua University, Yale University and Berkeley University
Shan Li	59	Board member	• Client-facing business; and government, regulatory and/or academia • Held many board and management roles in banking companies such as UBS Asia Investment Bank, Bank of China International Holdings, and Lehman Brothers Asia
Seraina Macia	54	Board member	• Client-facing business, finance and/or audit; and digitalisation and/or technology • Held board and management positions in Blackboard U.S. Holdings Inc, AIG Corporation, Hamilton Insurance Group, and Zurich Financial Services etc.
Blythe Masters	53	Board member	• Client-facing business, finance and/or audit; risk, legal and/or compliance; and digitalisation and/or technology • Previously CEO of Digital Asset Holdings LLC and took on many roles in JP Morgan Chase & Co.
Richard Meddings	64	Board member	• Finance and/or audit; risk, legal and/or compliance • Previously worked in many banking companies including TSB Bank, Deutsche Bank AG, Standard Chartered Group etc.
Amanda Norton	56	Board member	• Investment management; and risk, legal and/or compliance • Previously Chief Risk Officer in Wells Fargo, JP Morgan Chase, and Ally Financial. She was also the Head of Enterprise Risk Management in Bank of America.
Ana Paula Pessoa	55	Board member	• Client-facing business; finance and/or audit; digitalization and/or technology; ESG; and government, regulatory and/or academia • Previously Chief Financial Officer of the Organising Committee in the Olympic & Paralympic Games 2018, and the Managing Partner of the Brazilian branch in Brunswich Group

Source: Credit Suisse. (2022). Credit Suisse annual report 2022.

Board diversity

To ensure independent supervision and decision-making, the Swiss Code of Obligations mandates that the BOD possess the required qualifications and experience.[60] As shown in Figure 4, as of FY2022, 67% of Credit Suisse's BOD members have industry experience in financial services, 17% have experience in government and academia, and 8% each have experience in insurance, advertising, marketing, and media. Additionally, the Swiss Corporate Law Reforms stipulates "comply-or-explain" disclosure obligations for gender diversity on the BOD and EB of listed companies of at least 30% and 20% respectively, effective from 1 January 2021.[61] Credit Suisse met the requirement as of FY2022, by having 58% female BOD members and 36% female EB members, respectively.[62]

Figure 4: Board composition of Credit Suisse's as of end of 2022[63]



Source: Credit Suisse. (2022). Credit Suisse annual report 2022.

Compensation policies

In Credit Suisse's FY2022 annual report, the main purpose of its compensation policy was stated as achieving results with integrity and fairness by attracting, retaining, and motivating the employees.[64] The bank's capital position and economic performance were taken into consideration to balance the fixed and variable incentive compensation components, reflecting employee's value and responsibilities. The compensation policy for various employee groups includes EB compensation, BOD compensation, and group variable compensation.[65]

Executive board compensation

The EB's compensation consists of fixed and variable components [66] Fixed compensation includes base salary, role-based allowances, and pension and other benefits. Variable compensation, on the other hand, is tied to the achievement of annual financial and non-financial objectives, weighted at 70% and 30% respectively. [67] For FY2022, the performance levels for the financial metrics were not met, while the non-financial metrics achieved 84% of its target. Furthermore, due to the bank's reported loss for the year, no variable compensation was awarded. Hence, the EB received only fixed compensation for FY2022.[68]

Board of directors' compensation

Compensation for the BOD is determined on a fixed fee structure basis from one AGM to the next, with pre-established fees for BOD memberships, committee memberships, and committee chairs. Following industry practices, BOD fees were not tied to Credit Suisse's financial performance and fees for specific BOD leadership roles are assessed periodically and adjusted if necessary. For FY2022, the Chairman voluntarily waived his chair fee given Credit Suisse's challenging situation and poor financial performance for the year. [69]

Group variable compensation

Credit Suisse's variable incentive compensation pool is determined annually by the Compensation Committee, with quarterly accruals made during the year to align the pool's size with Credit Suisse's compensation objectives. The total amount of variable incentive compensation pool for corporate functions considers Credit Suisse's financial performance, non-financial factors, and changes in headcount.[70] The compensation structure for employees includes fixed compensation (base salary, allowances, pension, and benefits) and variable compensation (cash and deferred share awards). For FY2022, Credit Suisse's variable incentive compensation pool was significantly affected by its poor financial performance, resulting in the bonus pool being 50% lower than in FY2021, with 34% of the variable compensation awarded being deferred.[71]

UBS takes the Credit (Suisse)

> "This acquisition is attractive for UBS shareholders but, let us be clear, as far as Credit Suisse is concerned, this is an emergency rescue. We have structured a transaction which will preserve the value left in the business while limiting our downside exposure."
>
> – *Colm Kelleher, UBS Chairman*[72]

The UBS takeover of Credit Suisse, which many referred to as a "shotgun marriage", was anticipated to form a business exceeding US$5 trillion in total invested assets and sustainable value opportunities. This move was seen as elevating UBS's status as the leading Swiss-based global wealth manager, boasting a collective invested asset base of over US$3.4 trillion and active engagement in high-growth markets. Additionally, the acquisition reinforces UBS's position as the leading universal bank in Switzerland. The combined businesses will be a leading asset manager in Europe, with invested assets exceeding US$1.5 trillion.[73]

Meanwhile, Credit Suisse shareholders were to receive 1 UBS share for every 22.48 Credit Suisse shares held, totalling CHF 3 billion. The transaction also included CHF25 billion of downside protection for UBS, consisting of supporting marks, purchase price adjustments, and restructuring costs.[74] UBS Chairman Colm Kelleher emphasised the acquisition as an emergency rescue for Credit Suisse, aiming to preserve the remaining value in the business while limiting downside exposure. The discussions between UBS and Credit Suisse were initiated with the support of Swiss regulatory authorities.[75]

Swiss banking's power couple

On 12 June 2023, UBS completed the acquisition of Credit Suisse, crossing an important milestone. Credit Suisse was merged into UBS, and the combined entity will operate as a consolidated banking group.[76]

Switzerland's financial regulator FINMA said that the legal closure of the acquisition brought "clarity and stability for the two banks". In addition, FINMA was said to "welcome UBS's strategic focus, which [was slated to cause] a rapid reduction of risk in investment banking".[77]

Post-merger, UBS implemented substantial job cuts as part of its cost-saving strategy. While the situation is still evolving, there are indications that the impact of these cuts may be significant considering that the two banks collectively employ 37,000 individuals in Switzerland, constituting 18% of the financial sector's workforce, and have a global employee count of 120,000.[78] Preliminarily, it was said that "around 8,000 Credit Suisse employees left the bank in the first half of 2023, while 3,000 jobs will be lost over the next two years in Switzerland as UBS integrates its domestic business and other units in its home market."[79]

With assets double the country's annual output and local deposits equivalent to 45% of Switzerland's GDP,[80] the merged entity raises concerns about its impact on the national economy. Swiss taxpayers may be liable for up to CHF9 billion in potential losses from certain Credit Suisse assets. UBS anticipated significant costs and benefits from the acquisition, and acknowledged potential legal challenges, including litigation from Credit Suisse bondholders who had incurred losses.

Regarding the concern of taxpayers footing the bill, on 11 August 2023, UBS made a ground-breaking announcement by terminating the federal loss protection guarantee and the agreement between Credit Suisse and the SNB on liquidity assistance loans, both without replacements.[81] The decision came after the loans had been fully repaid, cementing the permanent termination of these guarantees. Switzerland did not incur any losses associated with these guarantees, and with their termination, the previously associated risks ceased to apply for Switzerland and its taxpayers.[82]

UBS' new structure

UBS and Credit Suisse will maintain independent operations in the immediate future, with UBS undertaking the integration of Credit Suisse in a phased approach. UBS is thus overseeing the management of the two distinct parent companies – UBS and Credit Suisse. Each institution retains autonomy over its subsidiaries, branches, clients, and counterparties. However, the ultimate responsibility for the consolidated group lies with UBS' board of directors and executive board. Throughout the ongoing integration process, Credit Suisse will adhere to its established governance and risk control frameworks.[83]

Ermotti makes a comeback

UBS appointed Sergio P. Ermotti (Ermotti) as CEO of UBS and the group, succeeding Ralph Hamers (Hamers), in response to evolving priorities following the acquisition of Credit Suisse. Hamers remained at UBS to support Ermotti during the transition. The decision aimed to stabilise Credit Suisse and ensure a seamless merger. Ermotti, a former CEO of UBS with extensive experience, was considered ideal for leading the integration. Hamers voluntarily stepped down to prioritise the success of the combined entity and its stakeholders. This decision reflects an acknowledgment of the integration challenges and underscores the importance of experienced leadership in steering the bank through complex changes.[84]

Continuing appointments

Additionally, UBS decided to retain Christian Bluhm (Bluhm) as Chief Risk Officer for the "foreseeable future" to strengthen controls during the integration of Credit Suisse. This move was part of CEO Ermotti's restructuring efforts following UBS' rescue of Credit Suisse. Damian Vogel, initially set to replace Bluhm in May 2023, instead assumed the role of Group Risk Control Head of Integration, overseeing risk functions related to the Credit Suisse deal. Ermotti emphasised the importance of having both senior risk leaders actively engaged to ensure readiness for future success in this key area.[85]

On 9 May 2023, UBS announced a new operating model and leadership team. The combined firm will operate with five business divisions, seven functions and four regions, in addition to Credit Suisse. Each will be represented by a group EB member, all of whom will report to CEO Ermotti.[86]

Lost bonds, angry investors

In the UBS acquisition of Credit Suisse, the Swiss government declared on 20 March 2023 that US$17 billion worth of Credit Suisse AT1 bonds would be marked down to zero, while shareholders would benefit by receiving shares from UBS.[87] Despite the increasing number of scandals and non-compliance issues Credit Suisse faced, one of its long-term clients bought US$500,000 worth of these bonds. He noted that: "Whenever [he] spoke to them, the bank gave [him] constant reassurances that this was just a blip, so [he] decided to go for it. It didn't feel like [he] was gambling."[88]

Individuals who purchased AT1 bonds faced an unfortunate outcome when Credit Suisse was acquired by UBS.[89] Many AT1 bondholders, upset over receiving nothing while shareholders gained something, a situation contrary to the conventional wisdom that creditors get paid before shareholders, have filed lawsuits against the Swiss authorities.[90] Legal representatives of the bondholders claim that the Swiss authorities' decisions are "unlawful" and have had "devastating consequences on thousands of retail and small investors globally."[91]

"Who in the world is going to trust Switzerland anymore?"

— *An Asia-based AT 1 bondholder* [92]

What are AT1 bonds?

AT1 bonds are a form of "contingent-convertible" bonds introduced after the global financial crisis of 2007-2009 to prevent government-funded bailouts of precarious banks.[93] The bonds are designed to absorb losses before a massive crisis can wipe out the entire equity of a bank. Based on the contractual terms of AT1 bonds, it is apparent that they stipulate a write-down to zero in the case of a write-down event, such as a viability event. A viability event occurs when a bank receives an irrevocable extraordinary support from the public sector,[94] typically in the form of financial support from the government, without which the bank would become insolvent, bankrupt, unable to pay a substantial part of its debts as they fall due, and unable to carry on its business.[95] Credit Suisse had received liquidity assistance loans secured by a federal default guarantee, meeting the conditions for a viability event. Therefore, the write-down of AT1 bonds to zero under these circumstances can be considered justifiable.[96]

Meanwhile, Credit Suisse's shareholders still received approximately one-tenth of the original equity they would have received three years ago. This came as a huge blow to AT1 bondholders who expected to have priority over shareholders in a bankruptcy proceeding, as stated in the contractual terms the "Events of Default" section. However, the paragraph following that section also states that bondholders' claims will be superseded by a write-down event. Only where there is no write-down event, would the bondholders rank above the shareholders.[97] Therefore, the bondholders' argument may not have a basis given the occurrence of a viability event, the true purpose of AT1 bonds and the formal contractual terms.[98]

Bondholders' litigation

In light of these justifications for the write-down of AT1 bonds, it was reported that bondholders who suffered severe losses plan to challenge the validity of the Swiss government's declared viability event through legal action. On 18 April 2023, Credit Suisse bondholders represented by the law firm Pallas Partners, with claims amounting to US$300 million, filed a lawsuit in the Swiss court against the Swiss regulator FINMA. The plaintiffs argue that FINMA had no authority to order the write-down and that it "...was an abuse of process and the resolution procedure should not be used by Switzerland to enable UBS to take over Credit Suisse to the detriment of AT1 holders."[99]

Furthermore, a larger group of AT1 bondholders, represented by US law firm Quinn Emanuel Urquhart & Sullivan, filed another lawsuit in Swiss court against FINMA, with claims totalling US$4.5 billion.[100] Lawyers at Quinn Emanuel were also preparing a lawsuit in the US courts against Switzerland, representing AT1 bondholders whose losses resulted from the state's decision to rescue Credit Suisse. It was reported that the case "...seek[s] compensation for the destruction of [investors'] property rights."[101]

Shareholders' litigation

On 16 March 2023, shareholders of Credit Suisse, represented by Braden Turner (Turner), filed a lawsuit against the bank claiming that it had failed to disclose significant issues including substantial customer outflows and identify material weaknesses in internal controls over the course of its financial reporting. Turner represents claimants who held Credit Suisse's American Depositary shares from 10 March 2022 to 15 March 2023.[102]

Subsequently, two other class action lawsuits were initiated against UBS. On 4 July 2023, the Ethos Foundation, representing a group of shareholders holding about 5% of shares in both Credit Suisse and UBS, announced its participation in a campaign led by LegalPass, a startup in Lausanne. LegalPass aims to challenge the terms of the takeover such as the exchange ratio set and seek a cash-based payout for its claimants which would cover the difference between the court-determined value of Credit Suisse and the price paid by UBS.[103]

The second class action lawsuit was filed by the Swiss Association for the Protection of Investors (SASV) representing approximately 1,000 shareholders of Credit Suisse, including former employees who had been given shares as part of their annual remuneration packages. SASV is filing the case on a not-for-profit basis, represented by Zurich-based law firm Niedermann Rechtsanwälte.[104] The claimants' case was that they not only suffered losses due to the hurried takeover but were also denied the opportunity to vote on the merger decision. SASV said that "[t]he takeover of the second largest Swiss bank by the largest bank had the character of horse trading, in which the purchase price was arbitrarily determined."[105]

Reportedly, employees of Credit Suisse were reluctant to file claims for their losses, as UBS is evaluating which employees to retain and who may be dismissed.[106]

The Singapore angle

In a class action lawsuit filed by law firm Withersworldwide, Singapore holders of Credit Suisse's AT1 bonds sought to sue the bank to recover about S$100 million[107] losses resulting from the bank's collapse. The AT1 bondholders involved in the lawsuit are predominantly individuals in their 50s who had been saving for retirement. Many of these bondholders felt aggrieved that they were sold the AT1 bonds without disclosure of the contingency clause that could render the bonds worthless. Some claimed that all they did was sign a set of documents as requested by their Credit Suisse relationship manager and were not made aware of the existence of such a high-risk clause. Consequently, these investors plan to sue for misrepresentation and mis-selling.

The Withersworldwide lawsuit intends to take "...a Singapore-centric approach, with emphasis on rights arising from the Singapore-Switzerland free trade agreement." This agreement sets forth regulations regarding transparent conditions for investors when making investments in the other territory. It also specifies guidelines for how investors should be treated in the event of losses and the legal avenues available to seek remedy for grievances.[108]

Swiss banking regulations

The Swiss banking and financial sector has a long tradition of self-regulation, complemented by statutory mandates enforced by FINMA. This framework allows for a significant degree of flexibility and customisation to address the unique aspects of the Swiss financial market.[109]

Secondly, a hallmark of Swiss banking is its secrecy laws enshrined in the Banking Act of 1934, which offer robust protection of client-related bank account information. This level of confidentiality, akin to attorney-client privilege, prohibits bank employees from disclosing customer information or bank-client relationships to third parties. Violations of these laws can result in severe penalties, including imprisonment for up to five years and fines up to CHF 250,000. Exceptions to these secrecy laws are limited and include circumstances such as suspected money laundering, court orders requiring banks to act as witnesses in legal cases, or asset seizures in debt collection cases.[110]

Thirdly, Swiss regulatory authorities mandate capital requirements that exceed the global Basel III standards. This approach, often referred to as the 'Swiss Finish', is modulated according to bank size and complexity, necessitating additional capital buffers for banks, particularly those classified above a certain threshold. Consequently, some institutions are required to maintain an extra capital buffer of 2.2% of their Risk Weighted Assets, surpassing the Basel III requirements. Furthermore, banks deemed 'Too-Big-To-Fail' are subject to even stricter capital requirements, including the use of Contingent Convertible Bonds or bonds with a write-down feature. These financial instruments are designed to convert into equity capital if the Common Equity Tier 1 ratio falls below a 5% threshold, thereby providing an additional layer of financial stability and risk mitigation.[111]

A better tomorrow?

The downfall of Credit Suisse and its subsequent acquisition by UBS have sparked widespread speculation about the future trajectory of Swiss banking. As part of the completion of the acquisition, UBS has revamped Credit Suisse's BOD, reducing its size to six members, with five new members from UBS joining the board alongside Clare Brady, who has been a board member of Credit Suisse since 2021.[112]

Leading the board is 59-year-old Chairman Lukas Gähwiler (Gähwiler), who previously served as Chairman of UBS for five years and is currently UBS' Vice Chairman. Prior to joining UBS, Gähwiler worked for Credit Suisse for over 20 years, with his last role being Chief Credit Officer, Global Private and Corporate Banking.[113]

The Vice Chair of the BOD of Credit Suisse is 66-year-old Jeremy Anderson (Anderson), who also holds the position of Senior ID at UBS. Anderson is a financial services veteran, with more than 30 years' experience working in the banking and insurance sector in an advisory capacity, covering a broad range of topics, including strategy, audit and risk management, technology-enabled transformation, mergers, and bank restructuring.[114]

Among the new board members is 60-year-old Michelle Bereaux (Bereaux), who was appointed UBS' Group Integration Officer in May 2023, responsible for the development and execution of integration strategy between UBS and Credit Suisse. Bereaux has been with UBS for more than 25 years, holding various leadership roles across the firm.[115]

Another addition to the board is 66-year-old Mark Hughes (Hughes), who also serves as a non-executive director of UBS. Hughes is a highly experienced professional in the financial services sector, having spent more than 35 years working for the Royal Bank of Canada in Canada, the US, and the UK.[116]

The final new board member is 50-year-old Stefan Seiler (Seiler), who also serves as the Head Group Human Resources & Group Corporate Services at UBS. Seiler joined UBS in 2011 and became Group Head HR in 2018 after gaining experience as Head HR for Switzerland and Group Functions, as well as Global Head Talent and Recruiting.[117]

There have also been significant changes to Credit Suisse's EB, with eight out of eleven members being new to the board.[118] Given these significant changes to Credit Suisse's BOD and EB, and its operation under a consolidated UBS banking group, can Credit Suisse reclaim its esteemed position among Switzerland's top financial institutions amidst ongoing bondholder and shareholder litigation?

Discussion questions

1. Critically evaluate the key contributing factors to the problems that Credit Suisse has found itself in prior to the acquisition by UBS.
2. Comment on the composition of Credit Suisse's board of directors before the acquisition by UBS. Are there red flags that should have raised concerns with investors? Explain.
3. Discuss how poor risk governance and management contributed to the issues at Credit Suisse. What lessons can other companies draw from Credit Suisse's risk management failures?
4. Comment on the role of the Swiss government in the acquisition of Credit Suisse by UBS. Could it possibly be said that the takeover was the most feasible decision to make? Explain.

5. How did stakeholders react to Credit Suisse's downfall, the UBS acquisition, and the subsequent cancellation of bonus payments? Is the decision to write off AT1 bonds justified? Consider whether this decision treated bondholders fairly in the broader context of other stakeholders and societal interests.
6. Critically evaluate the differences between unitary and dual board structure. What are the advantages and disadvantages of each board structure?
7. Even with regulatory compliance, Credit Suisse still collapsed. This raises questions about the adequacy of Swiss regulations. Assess the effectiveness of these regulations, comparing the Swiss governance and banking regulations to those in your own country.

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DISNEY: A FAIRYTALE NIGHTMARE?

Case overview

After more than a decade of triumphs under the leadership of Robert A. Iger (Iger), The Walt Disney Company (Disney) announced Iger's retirement and named Robert A. Chapek (Chapek) as Chief Executive Officer (CEO) on 25 February 2020. However, Chapek's stay as CEO was short-lived. On 20 November 2022, Disney announced that Iger will return as CEO, replacing his own hand-picked predecessor, Chapek. This announcement was unexpected as Disney had just renewed Chapek's contract and Iger had announced in 2020 that he would not return after his retirement, which had been postponed four times.

The objective of this case study is to facilitate a discussion of issues such as the impact of the COVID-19 pandemic on Disney's movie business; CEO succession and the role of current CEO in choosing a successor; the continuing involvement of former CEOs in a company; the role of executive chairmen; board composition; director duties; and executive compensation.

Once upon a time

The Walt Disney Company (Disney) was founded on 16 October 1923 by two brothers, Walt Disney and Roy O. Disney (Roy Disney) in Burbank, California, United States (US).[1] With the release of Steamboat Willie in 1928, the immensely popular character Mickey Mouse was introduced to the world and has since become one of the most recognisable cartoon characters in history.[2] This helped Disney establish itself as an animation industry leader.

After releasing consecutive hit animated cartoon films such as "Pinocchio", Disney achieved huge successes by the early 1940s and started to diversify into live-action films, nature documentaries and television programs later in the 1950s.[3] Disney initially issued over-the-counter stock in 1940, and later in November 1957, the company conducted its Initial Public Offering on the New York Stock Exchange at a share price of US$13.886.[4]

This case study was originally prepared by Jazlynn Lam, Ng Cheng Yee Trina, Ng Siew Hoong, Shanice Low Jing Ling and Teoh Cui Shan. It has been edited by Alden Wordsworth Ng and Koh Yan Qi, under the supervision of Professor Mak Yuen Teen, with additional content added. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees.

The opening of the Disneyland theme park in 1955 and Walt Disney World Resort in 1971 further strengthened Disney's position in the entertainment industry in the US.[5] However, in 1966, founder Walt Disney's death led the company into a financial turmoil coupled with a lack of direction in leadership. The company's profits, especially those from the animation division, began to fall.[6]

Who owns Disney?

The distribution of Disney's shares extends to institutions, mutual funds, the general public, and individual insiders. As of 30 December 2023, Institutional investors hold a significant portion, constituting 67.51% of Disney's shares, with Vanguard Group Inc. and BlackRock Inc. emerging as the top two institutional investors, holding 8.26% and 6.62% of the company's shares respectively.[7] Insiders, including Robert A. Iger (Iger), Christine McCarthy (McCarthy) and Alan Braverman, collectively own less than one percent of Disney's shares.[8] Meanwhile, the Disney family maintains ownership of less than three percent of the company.[9]

Eisner to the rescue

By the late 1980s and early 1990s, Disney was on a roll once again under the new management team led by Michael Eisner (Eisner) who took up the position of Chairman and Chief Executive Officer (CEO) of Disney in 1984.[10] Eisner appointed Jeffrey Katzenberg as the head of Disney's motion picture division, and together, they revived Disney's poorly performing animation studio with the production of hit movie films like "The Lion King".[11] This period of success is commonly referred to as the Disney Renaissance.[12] During Eisner's tenure, he also led the acquisition of Capital Cities/ABC in 1995 which allow Disney to expand into a broadcast and cable TV distribution and brought in millions of subscribers through ESPN.[13] Furthermore, Eisner developed the company's theme parks business globally, opened the Disneyland Paris and initiated the construction of Hong Kong Disneyland.[14] Under Eisner's leadership, Disney's share price skyrocketed and sales increased by 125% to US$3.75 billion.[15]

Eisner's downfall

However, Disney faced another downturn in the early 2000s, as a series of box-office bombs made Disney films unprofitable.[16] To make matters worse, Eisner was involved in a series of lawsuits and public feuds concerning Katzenberg[17] and Steve Jobs.[18] Continuous dissatisfaction with Eisner's management style prompted founder Roy Disney to initiate a "Save Disney" campaign.[19] At an annual meeting in March 2004, 43% of the voting shareholders voted against Eisner's reappointment as Chairman of the board of directors (BOD).[20] Under pressure from the campaign, Eisner announced in March 2005 that he would step down as CEO a year before the expiration of his contract, and would hand over his day-to-day duties to Iger before formally leaving Disney in September 2005.[21]

Bob Iger's epic odyssey

After taking over Eisner's position in 2005, Iger embarked on a 15-year journey as CEO of Disney to revitalise both Disney movies and theme parks. Iger pursued this goal through three key strategies — international expansion, the generation of fresh content, and the utilisation of the latest technology.[22]

Under Iger's leadership, Disney expanded its rich history of storytelling through major acquisitions, including Pixar in 2006, Marvel in 2009, Lucasfilm in 2012, and 21st Century Fox in 2019.[23] These acquisitions transformed Disney into the biggest name in franchise entertainment and a dominant player in the market.[24] Additionally, Iger revitalised several theme park flops by introducing new worlds and rides. [25] To strengthen Disney's theme park resort presence in East Asia, Iger opened Disney's first theme park and resort in Mainland China, the Shanghai Disney Resort in 2016.[26] Since its opening, it has attracted millions of visitors.[27]

In recognition of Iger's successful leadership, Disney received several accolades in both America and around the world.[28]

Not Iger to leave

Before stepping down as CEO in 2020, Iger had delayed his retirement four times, citing the absence of a suitable successor and the necessity to oversee the US$71.3 billion acquisition of the 21st Century Fox.[29]

Iger's pay increased to US$65.6 million in fiscal year (FY) 2018.[30] His compensation drew criticisms from Abigail Disney (Abigail), the granddaughter of Disney's co-founder.[31] Following the shareholders' vote against Iger's compensation package for FY2019, performance targets for Iger were raised. Additionally, US$500,000 was eliminated from Iger's base salary and his cash bonus reduced from US$20 million to US$12 million.[32]

According to Disney's 2022 Corporate Governance Guidelines,[33] one of the responsibilities of the board is the planning of CEO succession. It recommends that the CEO should meet with non-management directors no less than once a year to discuss potential CEO successors. Furthermore, the CEO should draft a confidential document highlighting the responsibilities of a CEO to facilitate handover procedures to his or her successor. This document should be reviewed periodically with the Chairman, Lead Independent Director, and the Governance and Nominating Committee. These guidelines were implemented in 2014 to minimise key person risk.[34]

Despite Iger complying with the guidelines, the BOD encountered difficulties with succession planning. Continuous postponement of his retirement had side-lined potential successors. Tom Staggs (Staggs), the Chief Operating Officer (COO) and Jay Rasulo, the Chief Financial Officer (CFO), were considered potential candidates as successors. However, both stepped down from their positions in 2016 due to the lack of assurance from the BOD that they would succeed Iger.[35]

Meet the new Bob

On 25 February 2020, Iger announced his intention to retire from his role as CEO, with plans to continue leading the BOD as Executive Chairman and direct Disney's creative endeavours until the end of his contract on 31 December 2021.[36] Hours after the announcement, Disney shares fell by around 2.5%.[37]

On the same day, Chapek was appointed as the CEO of Disney, and on 15 April 2020, he was officially elected to the BOD.[38] Chapek's selection came as a surprise to many as Kevin Mayer (Mayer), the former Head of Streaming of Disney, was widely expected to be selected given Disney's focus on growing its streaming service.[39] Following Chapek's nomination, Mayer, who had led the initial development of Disney's streaming service, Disney+, left the company, reportedly feeling "blindsided" by the decision.[40]

Mayer was not the only one to leave Disney following Chapek's appointment as CEO. Top executives Zenia Mucha and Alan Braverman, who played critical roles in several of Disney's pivotal developments, also announced their departure from the company at the end of 2021.[41] Additionally, Alan Horn (Horn), the former Chief Creative Officer at Disney Studios Content, retired on 31 December 2021.[42] Horn, a major figure in the media industry for over 50 years, had played a key role in growing Walt Disney Studios into one of the largest movie studios in Hollywood.[43]

Chapek was not a newcomer to Disney. Joining in 1993, he had a wealth of experience across various business segments within the company. Before becoming the CEO, Chapek had served as the Chairman of Disney Parks, Experiences and Products; Chairman of Walt Disney Parks and Resorts; President of the former Disney Consumer Products segment; President of Distribution for The Walt Disney Studios; and President of Walt Disney Studios Home Entertainment.[74] In fact, Iger had "hand-picked" Chapek as his successor.[44] During the 2020 Annual Meeting of Shareholders, Chapek's first annual meeting, Iger expressed to shareholders that he "[couldn't] think of a better person to succeed [him] in [that] role".[45]

Disney's leadership tango

After stepping down as the CEO, Iger became the Executive Chairman and Chairman of the board until 31 December 2021.[46] This dual appointment was said to be in line with Disney's Corporate Governance Guidelines, which state that the Chairman of the board should be an independent director, and that previous employment as CEO "will not disqualify a director from being considered independent following that employment".[47] In his capacity as Executive Chairman, Iger actively participated in Disney's management.[48] Insiders reported that he was acting as if he was still in the CEO position, significantly undermining Chapek's authority in the management of Disney.[49]

Towards the end of his tenure as CEO, Iger was focusing on the launch of Disney+.[50] Therefore, when Chapek started his term as CEO, one of his responsibilities was to build upon the strategy developed by Iger and Mayer to expand Disney's streaming business.[51] With Iger in the position of Executive Chairman, Chapek had to report to him as the CEO, limiting his full power and autonomy over the direction of Disney's streaming business.[52]

Furthermore, despite Iger selecting Chapek as his successor, Iger was constantly dissatisfied with Chapek's decisions. Insiders revealed that less than a month after Chapek's appointment, Iger disagreed with Chapek's decision to lay off employees from Disney's theme parks due to the COVID-19 pandemic.[53] Subsequently, Iger announced that he would actively guide Chapek through running the company during the pandemic.[54] Chapek reportedly felt that his authority had been threatened, and their relationship soured.[55] Although Iger had announced that he would be guiding Chapek, Chapek made major decisions without consulting Iger.[56] At Iger's party commemorating his departure as Executive Chairman in 2021, attendees shared that the two barely talked and tension could be felt.[57]

Letting it go… or not

The continued involvement of former CEOs with Disney after their resignation is not without precedent in the company's history. Two other CEOs, Donn Tatum (Tatum) and E. Cardon Walker (Walker), remained involved in the company after their resignation as CEO.[58] Tatum stepped down as CEO in 1972 but continued to serve as a director until his retirement in 1992, at which time he was named as director emeritus.[59] Walker retired as CEO in 1983 but extended his tenure on the board to oversee the completion of Tokyo Disney.[60] Even after the completion of Tokyo Disney, he continued to serve as a consultant until 1990 and remained on the board until 1999.[61]

On 31 December 2021, Susan Arnold (Arnold) took over Iger's position as Chairman of the board. She was subsequently replaced by Mark G. Parker in 2023.[62]

Chapek gets chopped

Shortly after taking over from Iger, Disney announced the closure of its theme parks worldwide due to quarantine measures imposed by the COVID-19 pandemic.[63] Despite this setback, Chapek's initial performance garnered approval from the board as he successfully navigated Disney's parks through the shutdowns and grew Disney+'s subscribers, reaching millions. This success led to the board's decision to renew and extend his contract until July 2025.[64]

However, the board's satisfaction with Chapek's leadership was short-lived. In the fourth quarter of FY2022, Disney's streaming division reported a loss of US$1.47 billion.[65] Earnings per share for that period dropped from 37 cents to 30 cents, falling well below analysts' expectations of 56 cents per share by approximately 47%.[66]

The end is near

On 12 October 2020, eight months into Chapek's tenure as CEO, he announced Disney's strategic reorganisation of its media and entertainment business.[67] This initiative aimed to centralise all the functions under CEO, aligning with Disney's expansion into the streaming industry.[68] Chapek formed a new Media and Entertainment Distribution group, tasked with overseeing operations and controlling the overall budget of the company's streaming service.[69] This reorganisation overturned Disney's traditional business structure, which had proven successful for decades, and faced immediate resistance from veteran Disney employees who found themselves losing control over the budgets of their respective divisions.[70]

In addition to internal challenges, some of Chapek's decisions received negative feedback from Disney's consumers. Chapek had announced an increase in ticket prices and fees of Disney theme parks to partially offset the company's streaming division losses.[71] This move, however, was met with frustration and disappointment from loyal fans.[72] CNN reported that Pete Werner, CEO of wdwinfo.com, one of the oldest Disney fan websites, felt that the company had "neglected its long-time fans and passholders".[73]

Now streaming: Black widow versus Disney

Adding to Chapek's challenges, on 29 July 2021, Scarlett Johansson (Johansson) sued Disney for releasing her Marvel film, Black Widow, on Disney+ while it was still screening in cinemas. Johansson claimed that her agreement with Disney's Marvel Entertainment stipulated an exclusive theatrical release for her film. Consequently, she sued Disney for loss of income, as her salary was largely dependent on the film's box-office performance. [74] In response, Disney released a statement suggesting that Johansson had a "callous disregard" for the global effects of the pandemic.[75] Chapek's management of the situation faced criticism from both the public and members of Disney's BOD, with the President of the Screen Actors Guild condemning Disney of "gender-shaming" Scarlett Johansson.[76]

Furthermore, there were concerns about Chapek's inexperience in dealing with media talents, leading to comparisons between Chapek's and Iger's approaches.[77] Despite Iger's role as Executive Chairman, a former Disney executive revealed that "Chapek and Iger [were] not spending time and comparing notes and working to mutual success, which is kind of what you look for in a succession plan" and that "talent is important.".[78] Chapek's poor handling of this situation was reportedly a reason for his subsequent removal as CEO.[79]

Politics into the fray with "Don't Say Gay"

During Chapek's tenure as CEO, Florida's Governor Ron DeSantis (DeSantis) signed a controversial "Parental Rights in Education" bill, famously dubbed the "Don't Say Gay" bill. This bill prohibits teachers in Florida's primary schools from discussing topics such as sexual orientation and gender identity in the classroom.[80] Given Disney's prominence in the region, with Walt Disney World Resort Orlando serving as a key tourist attraction and home to over 77,000 employees and their families, Chapek was faulted for Disney's initial silence on the bill[81] and contributing to the bill's passage given the company's political donations totaling around US$300,000 to elected officials in Florida who supported it.[82]

Chapek later responded by ceasing Disney's political donations and apologised in a statement to employees for not being a "stronger ally".[83] However, his statement did little to soothe employees' frustration, especially when compared to Iger's, who openly criticised the bill in a Twitter tweet.[84] In protest against Chapek's response, Disney employees staged walkouts[85] and social media movements emerged with hashtags such as #DisneyDoBetter and #WhereIsChapek. Disney employees also posted an open statement condemning Chapek's response.[86] It was reported that Chapek's lack of a definitive response to this controversial issue ruined his image both internally and externally, serving as a key driving force behind his failure and eventual downfall.[87]

The board 'strikes back'

> "Would Mr Iger consider coming back to run Disney again?"
>
> – *Susan Arnold, Former Chairman of the Board*[88]

In the summer of 2022, Disney's senior executives led an uprising against Chapek, ultimately resulting in his removal as CEO. According to the Financial Times, Disney executives, including CFO, McCarthy, expressed concerns about Chapek's management to the board.[89] This discontent followed Chapek's announcement of job cuts, prompted by Disney's poor financial performance as reported in its fourth fiscal quarter earnings on 8 November 2022.[90] McCarthy shared with the board her displeasure regarding the way Chapek addressed investors during the earnings call.[91] Following this, on 18 November 2022, the Chairman of the Board, Arnold called Iger and asked if he would "consider coming back to run Disney again?"[92]

Iger, "to infinity … and beyond?"

On 20 November 2022, Disney's BOD announced that Iger would return to lead the company and serve as CEO for a two-year term with immediate effect.[93] This decision came less than a year after Iger retired from the company.[94] The company highlighted the fivefold increase in market value achieved under Iger's previous leadership, emphasising that Iger had a "mandate from the board to set the strategic direction for renewed growth" while it continued to look for a long-term successor.[95] Iger's re-appointment was seen by observers as a reactive move by the company's board as Disney's share price had plummeted significantly and its streaming service was operating at a huge loss.[96] Commenting on Iger's reappointment, Arnold stated: "With Iger being seen as someone always a step ahead in the media and entertainment space, the rehiring of the CEO will give competitors such as Netflix and its founder Reed Hastings a further run for the video streaming money."[97]

The market lauded Iger's return. After the surprise announcement of his return as CEO, Disney's share price surged by 6.3%, rebounding from a decline of over 40% in 2022.[98]

Internal candidates

Before Iger was called back as CEO, Disney's BOD had in mind a few internal candidates to replace Chapek, but eventually concluded that they were too new and inexperienced.[99]

A potential candidate who was considered by the BOD was Dana Walden, the head of general entertainment content and she oversees the creation of original entertainment and news programming for Disney's streaming platforms, broadcast, and cable networks. However, she does not have much experience in business decisions and has generally spent most of her time in the creative division.[100]

Alan Bergman, who has stayed in Disney for more than 25 years, was another possible contender. He served as the Chairman of Disney's studio division and led the integration of Iger's acquisitions into Disney's overall content pipeline. However, unlike the other top executives, he lacked experience in various other divisions and his career mostly centred around studio content.[101]

Josh D'Amaro, Head of Parks, Experiences, and Products at Disney, was a name that was also considered by Disney's BOD. Despite being well-liked by his peers and thought to be a strong leader, he was said to lack the creativity that Iger is often highly praised for, and his resume was only focused on resorts and parks businesses.[102]

Rebecca Campbell, responsible for international content and operations, was another strong contender. Although she had experience managing the streaming business in the earlier days of Disney+, she was taken off that position and seen to fall short of having the hands-on business experience to manage the challenging decisions facing the company's media business.[103]

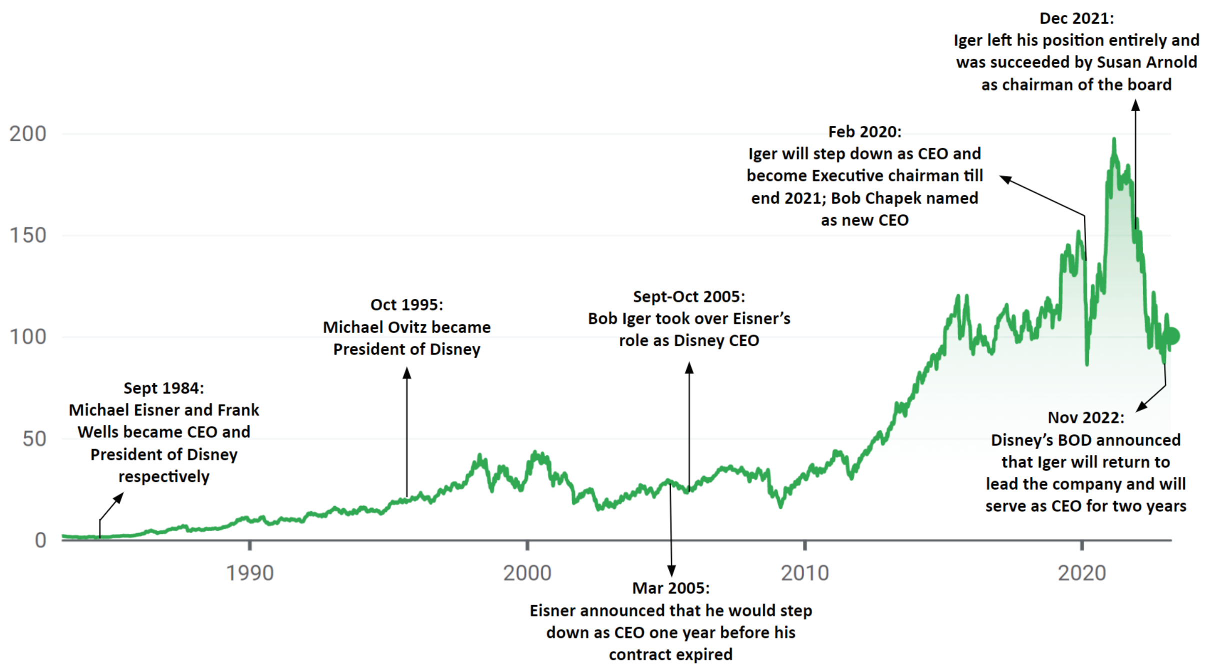
Finally, another candidate who was admired by the creative community, was Sean Bailey, the president of Disney Studios.[104] However, he too was not selected.

External candidates

Other potential candidates included former Disney executives, Staggs and Mayer, who were initially considered as successors to Iger before he ultimately chose Chapek in 2020. Both left the company after failing to secure the CEO role in 2016 and 2020 respectively.[105] After Chapek was ousted, many expected Mayer to be the likely successor and placed him at the forefront of the list once again.[106]

Figure 1 below charts the share price movement from March 1970 to March 2023, after the return of Iger.

Figure 1: Disney share price from March 1970 to March 2023[107]



Source: Google Finance. (2023, March 31). Walt Disney Co (DIS) Stock Price & News.

Bob the builder, can he fix the problem of CEO succession?

Disney's bylaws state that the management team should be chosen by the BOD.[108] However, with Iger also serving on the board as the Executive Chairman, he had a large say in his successor. Previously, Iger persuaded the BOD to appoint Chapek as the CEO by strongly expressing his support for him.[109] Shortly after, this hand-picked successor was removed and Iger went on to reassume this role. Given the failure of the previous succession plan, identifying the next successor before the end of his two-year term became one of his primary responsibilities.[110]

In early 2023, Nelson Peltz (Peltz), an activist investor, requested a seat on the board to oversee the succession planning.[111] However, Disney rejected this request on the grounds of his lack of experience in the media industry.[112] However, only two directors on the board had relevant media expertise: Carolyn N. Everson (Everson) and Iger.[113]

Behind Disney's Magic

As of 31 December 2023, the board is comprised of 11 directors, with Mark G. Parker serving as the Chairman. A brief breakdown of the board is shown below.[114]

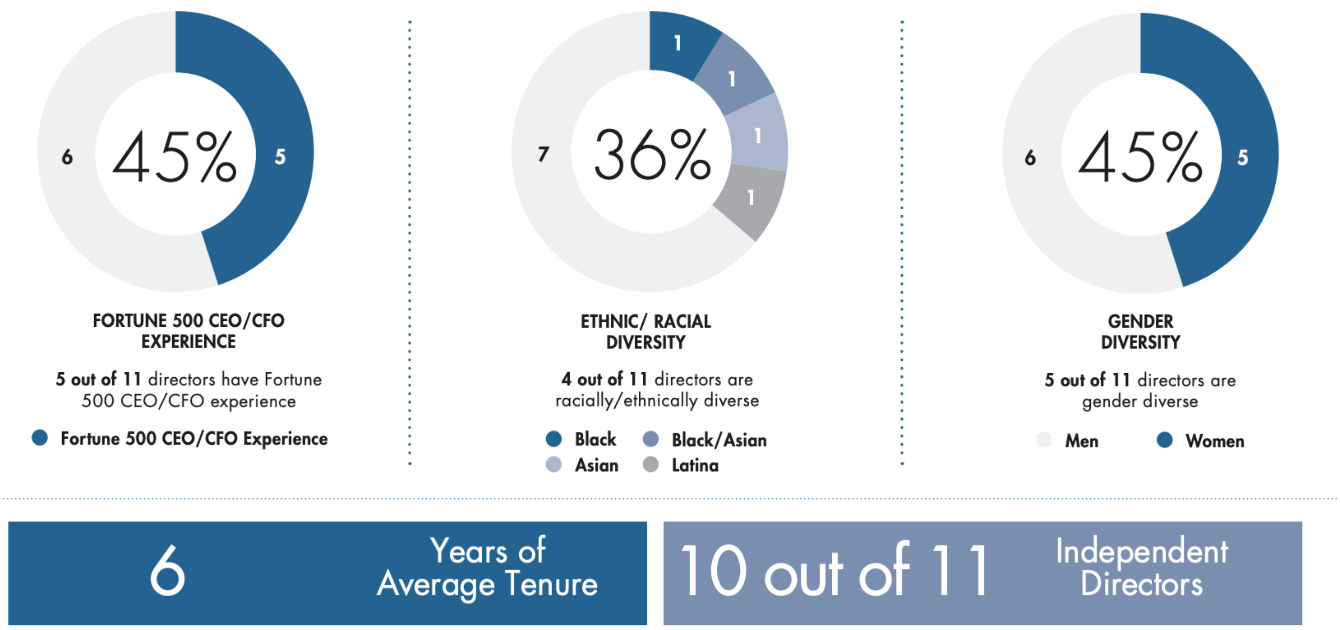
Figure 2: Disney's board of directors as at 31 December 2023[115]

Name	Gender	Age	Board Committee
Mary T. Barra	Female	61	• Compensation Committee (Member)
Safra A. Catz	Female	61	• Audit Committee (Member, Ex-Chairman)
Amy L. Chang	Female	46	• Governance and Nominating Committee (Member)
Francis A. Desouza	Male	52	• Audit Committee (Member)
Carolyn N. Everson	Female	51	• Compensation Committee (Member)
Michael B.G. Froman	Male	60	• Governance and Nominating Committee (Member)
Robert A. Iger	Male	72	• Executive Committee (Member) • CEO of The Walt Disney Company
Maria Elena Lagomasino	Female	73	• Governance and Nominating Committee (Member) • Compensation Committee (Chairman)
Calvin R. Mcdonald	Male	51	• Compensation Committee (Member)
Mark G. Parker	Male	67	• Executive Committee (Chairman) • Governance and Nominating (Chairman)
Derica W. Rice	Male	58	• Audit Committee (Chairman)

Source: The Walt Disney Company. (2023, January 24). Form 10-K/A (Amendment No. 1).

Based on Disney's 2023 Proxy Statement, 36% (or four out of eleven) of the directors are racially or ethnically diverse and 45% of their directors are women.[116] 10 out of 11 directors on the BOD are independent, with Iger being non-independent.[158] Former board Chairman, Arnold, did not stand for re-election,[117] which is in line with Disney's Corporate Governance Framework, where non-management directors who have served for more than 15 years are not to be re-elected[160], with Mark G. Parker replacing her in 2023.[118]

Figure 3: Profile of Disney's board of directors[119]



Source: The Walt Disney Company. (2023, February 10). 2023 Proxy Statement.

Board Committees

Disney has four committees, namely the Audit Committee (AC), the Compensation Committee (CC), the Governance and Nominating Committee (GNC), and the Executive Committee (EC).[120] Each member of the BOD is on at least one of the committees.

Board Competencies

According to Disney's 2023 Proxy Statement, the BOD possesses skills that are "directly relevant to the company's business and strategic objectives".[121]

Besides Everson and Iger, the remaining board members do not have experience in the media, entertainment, or theme parks industry.[122] However, according to Disney, these members contribute expertise in areas vital to Disney's strategy.[123] All members possess skills in areas such as brand management, marketing, and retail, with eight members specialising in direct-to-customer expertise which is a major business segment, and six members bringing technology and innovation skills to enhance the company's responsiveness and strategies in adapting to emerging trends.

The AC consists of three members, including Safra A. Catz and Derica W. Rice, who bring CFO experience from their previous roles, and Francis A. Desouza, who has served as President and CEO in various companies, providing expertise in financial and accounting matters.[124]

Meanwhile, the members of the CC and GNC have senior management experience, bringing the skill sets and experiences as shown in Figure 4.[125]

Figure 4: Disney's board of directors skill sets and experiences[126]

Director	Skill Sets and Experiences Relevant to Disney
Mary T. Barra	• Vice President of Global Human Resources from 2009 to 2011 before becoming the Chairman and CEO of General Motors Company. • Provide insights into human capital management and executive compensation-related matters.
Carolyn N. Everson	• Experience in branded, consumer-facing technology and media areas. • COO and Executive Vice President of Advertising Sales for MTV Networks Company, a media entertainment company. • Provide insights from her directorships in other public companies.
Maria Elena Lagomasino	• Past experiences as CEO and Chairman of companies. • Brings insights regarding executive compensation-related matters, overseeing alignment of incentive structures with shareholder value creation and execution of long-term strategic priorities. • Knows global brands, business development, executive management succession planning and risk management.
Calvin R. Mcdonald	• Former President and CEO of three companies. • Knows finance and accounting, risk management, corporate governance, and social initiatives.
Mark G. Parker	• Former President and CEO of NIKE, Inc. • Has experience in workforce and human capital management including managing creative talent and compensation and executive management succession planning.

Director	Skill Sets and Experiences Relevant to Disney
Amy L. Chang	• Prior roles include Executive Vice President at Cisco Systems, CEO of Accompany, Inc., and public company directors. • Has a well understanding of strategic planning, corporate governance, social initiatives, and executive management succession planning.
Michael B.G. Froman	• Prior roles in the government as Assistant to the President and Deputy National Security Advisor for International Economic Policy as United States Trade Representative and as CEO and COO in Citigroup. • Skills in international trade, finance, executive and brand management, and risk management.

Source: The Walt Disney Company. (2023, February 10). 2023 Proxy Statement.

Compensation conundrums

When Chapek was removed as CEO in November 2022, Disney disclosed that he would be able to take home a severance pay package worth around US$20 million which was in addition to the US$24 million that he made from the prior year.[127] In Disney's Securities and Exchange Commission (SEC) Form 14A filing, the US$20 million severance pay package consisted of US$6.5 million in remaining base salary, US$1 million pro-rated target bonus for FY2023, and a restricted stock unit valuation of US$12.7 million.[128] Given that Chapek had only been in Disney for less than two years, this US$20 million was seen as a "golden parachute".[129]

In addition to Chapek, another executive, Geoffrey S. Morrell (Morrell), also received a large pay-out when he left the company. Morrell joined Disney on 24 January 2022, and his employment was terminated on 30 June 2022. Serving as the former Senior Executive Vice President and Chief of Corporate Affairs, Morrell's total compensation for his five months in Disney amounted to a total of over US$8 million.[130] The total amount comprised of a US$2.75 million bonus, a US$0.5 million base salary, over US$1 million in option awards, nearly US$3 million in stock awards, among others.[131] In addition, according to the SEC filing, if Morrell "successfully completes all of the terms of his post-employment consulting agreement and general release," he will also retain his cash sign-on bonus of US$2.8 million to replace compensation from his previous employer, US$0.5 million to accommodate relocation costs, US$0.5 million for other personal benefits, US$2.5 million in remaining base salary, US$1.5 million target bonus for FY2022, and the buyout of a home he purchased in Southern California.[132]

Robin Hoods?

In January 2023, Peltz's Trian Fund Management LP, announced that it "believes Disney has excessive compensation practices and lacks cost discipline".[133] This was in response to Morrell's pay revelations, which the activist investor Peltz described as being "over the top".[134]

Peltz's allegation was not out of the blue. In 2019, Disney's heiress Abigail criticised Iger's compensation, deeming it "insane" and as having "a corrosive effect on society".[135] Abigail stated that Iger "could have given personally, out of pocket, a 15% raise to everyone who worked at Disneyland and still walked away with US$10 million". She made her remarks after interacting with Disneyland employees who had received lower benefits and experienced difficulties in affording their basic necessities.[136] Similarly, in another interview, Abigail criticised the disparity between CEOs' pay and the pay of an average worker.[137] Responding to a study revealing that Iger's pay was 1,424 times that of the median Disney employees,[138] Abigail stated that: "Jesus Christ himself isn't worth 500 times his median workers' pay".[139]

Likewise in 2021, when Disney released their executive compensation numbers, there was unhappiness with the figures, given the layoffs during the pandemic.[140] Twitter (now X) became a platform for criticism, with one user commenting, "How many of those workers laid off do you think could have increased quality of life if JUST Chapek's salary was lowered by $4 million and spread among them? He'd be JUST FINE with 10 mil instead of 14."[141]

Mirror mirror on the wall, what is Disney paying them all?

Based on a 2021 survey, the median compensation for a director at the 100 biggest companies in the US was US$310,000.[142] In contrast, "every member of Disney's board earned in excess of US$350,000 in 2022."[143]

According to the 2023 Proxy Statement, Disney's director compensation for FY2022 comprised of three main components: fees earned or paid in cash, stock awards, and all other compensation. Fees and stock awards made up 84% to 100% of the independent directors' total compensation.[144] The fees earned or paid in cash includes annual board retainer, annual committee, and committee-chair retainers, and can either be paid currently or deferred, either in cash or shares after service ends.[145] Eight of the directors opted to receive their fees through stock units that are either deferred or distributed as shares throughout the year.[146] Stock awards refers to the market value of the deferred stock unit granted to the director and the amount is based on the market value of Disney's common stock on the date of the award multiplied by the number of shares underlying the unit.[147] All other compensation includes reimbursement of tax liabilities associated with product familiarisation benefits, interest earned on deferred cash compensation, matching charitable contributions of the company and reimbursed security charges for equipment and security services.[148]

As per Disney's Corporate Governance Guidelines, directors are encouraged to own or acquire shares of Disney common stock (including stock units received as director compensation) within three years of first joining the board. The shares should have a market value of at least five times the annual board retainer for the director, which is set at US$115,000.[149] It was also disclosed in the 2023 Proxy Statement that each of the serving director had complied with the minimum holding requirement as of 23 January 2023, except for Amy L. Chang, Everson, and Calvin R. McDonald who had been on the BOD for less than three years.[150]

Deja vu

Disney has faced legal action in the past regarding excessive compensation. In October 2004, a group of Disney shareholders brought a case to the Delaware Court of Chancery claiming that the BOD failed in their responsibilities when they (1) approved CEO Eisner's hiring of Michael Ovitz (Ovitz) as Disney's president in 1995 and (2) allowed him to retain his full severance package when he was ousted just 14 months later.[151] The shareholders sought to recoup the US$140 million severance package paid to Ovitz in 1996, and an additional US$40 million in interest.[152]

The lawsuit revealed that the CC Meeting held on 26 September 1996 to discuss the proposed terms of Ovitz's employment agreement was only an hour long.[153] Chaired by Irwin Russell (Russell), a Disney director, the committee included Raymond Watson, a former Disney board Chairman, and directors Sidney Poitier and Ignacio Lozano.[154] Ovitz's employment agreement was proposed by Russell and Eisner before it was passed to the CC for final approval.[155] It was also revealed that Eisner had signed a letter agreement with Ovitz and issued a press release announcing Ovitz's hiring before any formal committee or board action had been taken. The court considered the duration of the meeting as a factor in determining the sufficiency of discussion on the employment terms.[156] While there is no standard duration for a committee meeting as it varies with the agenda, some companies address it in one-hour sessions or three-hour meetings.[157]

The Chancery court ultimately ruled in favour of the board, holding that the board had not breached their fiduciary duties in hiring and subsequently firing Ovitz with a US$140 million severance package. This ruling was upheld by the Supreme Court of Delaware on appeal.[158]

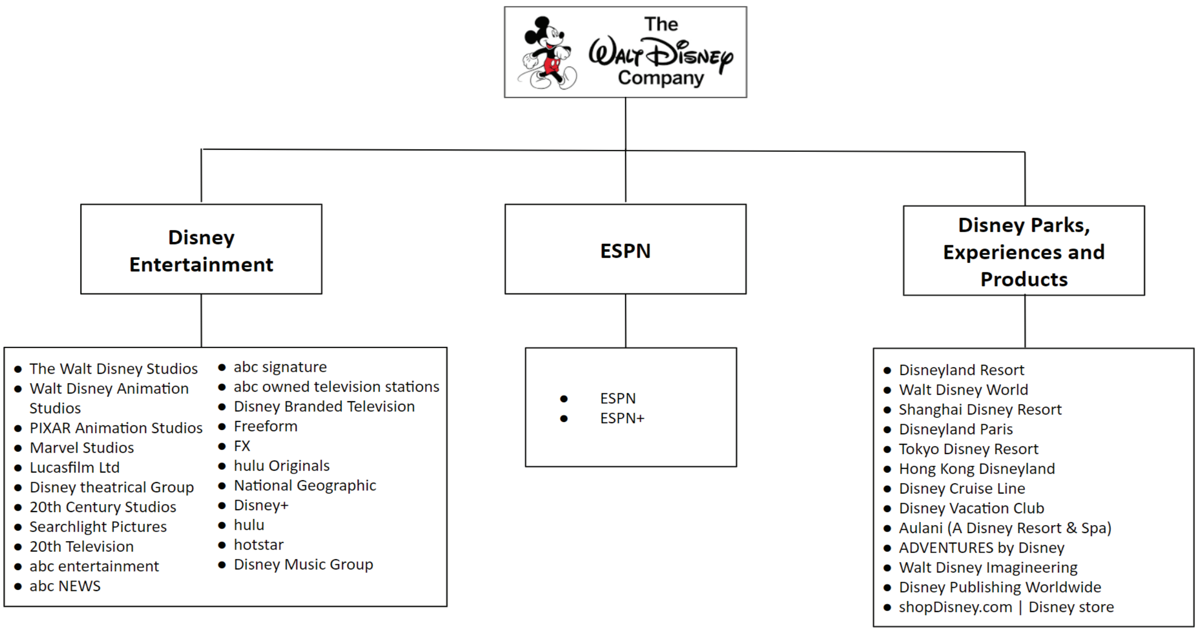
> "Although the compensation committee's decision-making process fell far short of corporate governance "best practices," the committee members breached no duty of care in considering and approving the [Non-Fault Termination terms] of [Ovitz's Employment Agreement]".
>
> *- Chancellor, William Chandler III*[159]

Commenters have remarked that the case highlights a gap in the ability of shareholders' to take action against boards that arises from the presumption embedded within the business judgement rule, given that the court ruled that "even if the board's actions fell well below best practices in making an executive compensation decision, the [shareholder] plaintiffs are unable to rebut the [evidentiary presumption that the director's had acted in the best interest of the company as imposed by the] business judgement [rule even] if [it could be shown that] the […] [BOD] and compensation committee had taken the minimal steps to inform themselves".[160] It is, after all, very difficult to prove a negative, especially as a shareholder with limited insight to the inner workings of a company or its board. Courts have been alive to this criticism of the judge-made business judgement rule in recent years, and legal commentary suggests that while "it is difficult to speculate, […] the [court'] call may have been much closer", and the case may have "come out differently if Ovitz had been hired and fired using the same processes now".[161]

Happily ever after?

With Iger back in the office, change spread across Disney. In 2023, the company stated that it will be undergoing a restructuring into three core business segments and announced mass layoffs.[162] The restructuring aimed to "refocus the organisation on creativity, empower creative leaders and ensure they are accountable for all aspects of their businesses globally".[163] To that end, Disney closed their Metaverse division, reduced headcount for ABC News executive team and laid off Isaac Perlmutter, the Chairman of Marvel Entertainment.[164] Figure 5 shows the revamped structure of Disney.

Figure 5: Disney core business lines[165]



Source: The Walt Disney Company. (n.d.). About the Walt Disney Company.

Iger remarked that the reorganisation would be a key element of a transformation that would rationalise Disney's streaming business towards sustained growth and profitability while reducing expenses amid global economic challenges.[166]

Succession planning committee

To address specific management issues such as CEO succession, Morrell's termination and the appointment of key management personnel, a Succession Planning Committee was established in January 2023.[167] The committee is chaired by Chairman Mark G. Parker with directors Mary T. Barra, Francis A. Desouza, and Calvin R. Mcdonald as the other members.[168] The committee's primary objective is to find a successor for Iger. It will be responsible for developing a timeline for the CEO search process and the recruitment process, including conducting interviews and engaging a search agency to screen candidates.[169] Additionally, the committee is required to discuss plans during allocated timings in BOD meetings with and without Iger's presence.[170] The committee does not have full discretion over the CEO selection as its decisions are subject to reporting to the BOD, which retains the right to make final decisions about CEO succession.[171]

Taking a stand

In the first quarter of 2023, Disney's launched a public response against Florida's "Don't Say Gay" Bill. This was met with opposition from Florida's Republican lawmakers, who approved a bill to restrict Disney's control over its theme park complex, known as the Reedy Creek Improvement District.[172] Governor DeSantis, a key player in the bill's approval wrote in a fund-raising email stating, "If Disney wants to pick a fight, they chose the wrong guy".[173]

This bill has allowed the governor to select members of the district board overseeing development at Walt Disney World and renaming it the "Central Florida Tourism Oversight District".[174] However, Disney did not concede without a fight. On 8 February 2023, before DeSantis signed the bill, Disney obtained approval to secure development rights for the next three decades under the old district board, rendering the new district board's authority useless.[175] In response, the new district board announced plans to nullify the agreement, leading to a legal standoff.[176] To resolve this, Republican lawmakers passed a law allowing the new district board to cancel the previous agreement between Disney and the old board.[177] In response, Disney filed a lawsuit against Governor DeSantis for violating its freedom of speech and has besieged the new district board with litigation on its validity.[178]

However, a federal judge ruled that Disney cannot sue the governor and his handpicked board, saying that "the statute reshaping the leadership structure and granting DeSantis the authority to appoint every member of the tax district's governing body is 'facially constitutional' and cannot be struck down with a free speech claim".[179] Disney has appealed the ruling to a federal appeals court.[180]

The Force is with Iger…

Disney faced another battle in January 2024 when activist investor Peltz nominated himself and former Disney CFO, Jay Rasulo, for a second time to Disney's BOD, setting the stage for another proxy fight. Through his investment fund, Peltz reiterated his 2023 stance that the "root cause of Disney's underperformance" is that the BOD is "too closely connected to long-tenured CEO", Iger, leading to a lack of "focus, alignment and accountability."[181]

Standing on the side of Peltz is Ike Perlmutter, the former head of Marvel who sold the publisher to Disney in 2009. Perlmutter worked at Disney until he was fired a year ago. In October 2023, he gave Peltz the voting rights of his Disney shares.[182]

However, many heavyweights have thrown their support behind Iger and the Disney board. These include JPMorgan Chase's Chairman and CEO, Jamie Dimon, who called Iger "a first-class executive and outstanding leader".[183] JPMorgan Chase has earned tens of millions in fees through a long-standing relationship with Disney and is also representing Disney in its fight against Peltz. Others supporting Iger and the board include eight grandchildren of Walt and Roy Disney, and George Lucas, the largest individual shareholder in Disney.[184] Lucas received 37.1 million Disney shares as part of Disney's US$4.05 billion purchase of his Lucasfilm studio in 2012.

Proxy advisory firm, Glass Lewis, recommended that shareholders vote to re-elect all the Disney directors.[185] Another proxy advisory firm, Institutional Shareholder Services (ISS), however, recommended a vote for Peltz but not Jay Rasulo, citing concerns that his potential presence might create added friction to the board. ISS also advised withholding a vote for current Disney board member Maria Elena Lagomasino.[186] In its report, ISS stated, "Dissident nominee Peltz, as a significant shareholder, could be additive to the succession process, providing assurance to other investors that the board is properly engaged this time around."[187] In response, Disney stated that ISS' recommendation "fails to acknowledge the diverse set of skills and experience on Disney's Board," [188] and it "strongly disagrees" with ISS's recommendation, asserting that Peltz "does not bring additive skills to the board."[189]

At Disney's Annual General Meeting (AGM) on 3 April 2024, shareholders elected all of management's choices to the board. Iger was re-elected with 94% support, while Peltz garnered 31% of the votes.[190] Iger addressed the shareholders, stating "With the distracting proxy contest now behind us, we're eager to focus 100 per cent of our attention on our most important priorities: growth and value creation for our shareholders and creative excellence for our consumers."[191]

In the aftermath of the victory, Iger's ultimate legacy at Disney remains uncertain with many big challenges unresolved. These challenges include revitalising the struggling movie business, selecting the company's next CEO, ensuring profitability in Disney's streaming sector, and transitioning ESPN from a traditional cable TV sports network to a dominant player in online video.[192] The question remains: Can Iger and the BOD successfully navigate these obstacles in a post-COVID-19 world?

Discussion questions

1. Analyse the strategic decisions made by Chapek during his tenure, especially in response to challenges like the streaming industry's growth and the impact of the COVID-19 pandemic. Were these decisions aligned with Disney's long-term goals?
2. Critically evaluate the effectiveness of Disney's existing succession planning framework, considering the unique challenges posed by the entertainment and media industry. Identify and propose specific areas where the current succession plan could be strengthened. Also, discuss the importance of succession planning in mitigating key person risk.
3. Critically evaluate the composition of the board of directors. To what extent do you think how the board composition reflects and/or can deliver on Disney's vision, values, and strategy? Also consider how the board's composition affects the board's performance, oversight, and decision-making.
4. Examine the board of directors' role in succession planning and assess the ideal level of CEO involvement. To what extent do you think Iger's involvement has contributed to the series of problem faced by Disney? Explain.
5. Explore the responsibilities of an Executive Chairman and determine their appropriate level of involvement in the company's management. Should former CEOs remain on the board after stepping down from their position? Explain your reasons by examining the advantages and disadvantages of retaining former CEOs on the board.
6. Before his second stint as CEO, Iger held the roles of Executive Chairman and independent director concurrently, as permitted by Disney's Corporate Governance Guidelines. Evaluate the potential conflicts of interest, if any, and consider whether such dual roles align with best practices in corporate governance.

7. Evaluate Disney's compensation policies and determine the reasonableness of these practices, considering specific instances such as the severance packages for Chapek and Morrell. Examine the impact of Disney's executive compensation practices on shareholder perceptions.
8. Activist investor Nelson Peltz waged a proxy battle against Disney, seeking board seats and other changes aimed at boosting Disney's share price. Critically evaluate the role of activist investors like Peltz in corporate governance. Do you believe that Disney shareholders should support the appointment of Peltz and his nominees to the Disney board? How might their appointment affect board effectiveness? Explain.
9. Compare the rights of minority shareholders to nominate directors in U.S. public companies versus your country, and how minority shareholders can do so. Which approach do you prefer? Explain.

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FIRST REPUBLIC BANK: ONE BIG CRASH

Case overview

First Republic Bank (FRB), a regional bank that focused on servicing high-net-worth clients, collapsed in 2023, making it the second-largest bank failure in US history since the collapse of Washington Mutual during the global financial crisis in 2008. The bank crumbled following a series of regional bank collapses that began with Silvergate Bank in March 2023. Following its collapse, FRB was taken over by the Federal Deposit Insurance Corporation (FDIC) and was subsequently sold to JP Morgan.

The collapse was sparked by significant devaluation of deposits and assets, attributable to efforts by the US Federal Reserve to curb inflation through swift interest rate hikes. These hikes created a wave of unease amongst high-net-worth clients who became privy to the true extent of asset devaluation. This prompted them to rapidly withdraw their funds, triggering a bank run. A large proportion of accounts far exceeded the FDIC insurance coverage limit of US$250,000, exacerbating the bank run. Investors quickly sold their shares which caused its equity value to plummet.

The objective of this case is to facilitate a discussion of issues such as corporate governance of banks; reasons for the bank collapse; risk management; board composition; US regulatory issues; and corporate governance in the US.

Bird's eye view

First Republic Bank (FRB), a regional bank headquartered in San Francisco, California, was founded in 1985 by James H Herbert II as an industrial loan company.[1] FRB rapidly developed into a state-chartered bank within a short span of 12 years. In 1993, FRB completed a reverse merger of its original holding company into Silver State Thrift, a Nevada based savings and loan association, in anticipation of the banking reform bill that was being

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discussed by the government.[2] In 1997, the banking reform bill was passed, allowing FRB to become a full state-chartered bank which could provide a larger range of banking services.[3] FRB then started catering primarily to affluent clients by providing a myriad of services that included private business banking, private banking, and private wealth management services.[4] FRB grew to become the 14th largest bank by asset size in the US with US$212.6 billion of assets as of 31 December 2022.[5]

Over the course of its history, FRB was publicly listed twice, first in 1986 when 840,000 shares were issued at a price of US$10 per share on the National Association of Securities Dealers Automated Quotations (NASDAQ) stock exchange.[6] In 2007, it was acquired by Merrill Lynch for US$1.8 billion in cash and stock.[7] Within three years, FRB regained a ticker after a consortium of investors that included General Atlantic, Colony Capital, and James Herbert acquired the bank and relisted it through its second Initial Public Offering (IPO) when 12.6 million shares were issued at US$25.50 per share on the New York Stock Exchange (NYSE).[8]

FRB had several well-known shareholders such as The Vanguard Group, BlackRock, and State Street Global Advisors who held significant stakes in the bank. Figure 1 shows the 10 largest shareholders as of 31 December 2022:[9]

Figure 1: FRB's ten largest shareholders[10]

Shareholder Name	Ownership (%)	Market Value (US$ million)
The Vanguard Group, Inc	11.241	2,506.4
Capital Research and Management Company	7.548	1,683.0
BlackRock, Inc.	7.194	1,604.0
State Street Global Advisors, Inc.	5.266	1,174.2
Alecta Pensions	3.890	867.3
Select Equity Group, L.P.	2.736	610.0
RBC Global Asset Management, Inc.	2.711	604.5
Geode Capital Management, LLC	2.022	450.9
Harding Loevner LP	1.796	400.4
Principal Global Investors, LLC	1.580	352.2

Source: S&P Capital IQ. (2023). First Republic Bank (OTCPK:FRCB) Public Ownership.

Timeline to collapse

The first signs of trouble for FRB emerged in January 2023. Though the bank had performed well financially, FRB's interest expense had increased by 2,040% year-on-year and 153% over the prior quarter.[11] Although the interest expense increase was abnormal, there was not much panic amongst clients and investors then as the company had just seen off a good quarter and year from a financial perspective.[12]

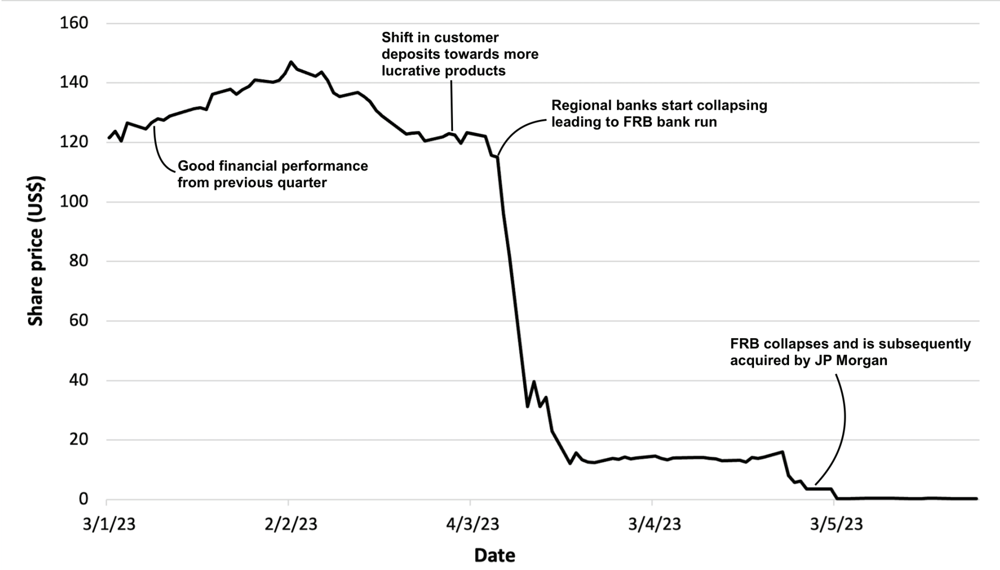
In February 2023, when the annual report for financial year (FY) 2022 was released, FRB revealed that a significant portion of its loan portfolio was tied to real estate assets.[13] It also highlighted a shift in customer deposits towards more lucrative financial products and asset classes, which was attributed to the escalating interest rate environment.[14]

In March 2023, Silvergate Bank, Silicon Valley Bank (SVB), and Signature Bank collapsed within a week and several credit rating agencies downgraded FRB's credit rating, highlighting a lack of confidence in the bank's financial stability.[15] This created significant unease amongst both investors and clients and led to a 75% decline in FRB's share price during the first half of March.[16] Consequently, 11 of the largest American banks initiated a government-backed initiative, infusing FRB with a total of US$30 billion in uninsured deposits to alleviate fears of a collapse.[17] Additionally, the US Federal Reserve (Fed) and the Federal Home Loan Bank (FHLB) collaborated to provide loans totaling US$105.4 billion.[18] These efforts however, did not alleviate investor concerns as the share price remained at all-time lows.[19]

In April 2023, FRB reported that its deposit base experienced a 41% decline since December 2022.[20] It announced plans for several strategic initiatives to keep the bank afloat.[21] This included a workforce reduction of up to 25%, alongside other measures which were intended to curtail costs and improve the overall financial stability of the bank.[22] FRB's troubles were further compounded when the bank reported on 28 April 2023 that it had taken on US$121.3 billion in borrowings and had reached a point where it would no longer be able to obtain further funding access.[23] This proved to be the final nail in the coffin. Within three days, on 1 May 2023, the Federal Deposit Insurance Corporation (FDIC) announced the closure of FRB and the sale of most of the bank's deposits and assets to JP Morgan.[24]

Figure 2 shows the share price movement of FRB and several significant events over a span of four months leading up to its collapse.[25]

Figure 2: Share price chart of FRB before collapse[26]



Source: Yahoo! Finance. (2023, November 16). First Republic Bank (FRCB) stock historical prices & data.

Business model – A double-edged sword

> "'Wealthy customers were drawn to First Republic in part because they could get large mortgages at rock-bottom interest rates,' said McCoy. Now that rates are much higher, those bargain mortgages are worth far less to potential buyers. 'That is putting a lot of strain on banks.'"
>
> – *Lawrence Delevingne, Journalist at Reuters*[27]

FRB's balance sheet primarily consisted of cheap mortgages extended to affluent customers, leaving the bank vulnerable to substantial paper losses on its mortgage portfolios as the Fed aggressively raised interest rates to combat inflation.[28] An example of such loans is the case of Facebook founder Mark Zuckerberg, who secured a 30-year mortgage of US$5.95 million from FRB on a Palo Alto, California home at an interest rate of 1.05%.[29] In a January 2023 investor presentation, FRB touted its impressive shareholder returns, compounding at 19.5% annually, which significantly outpaced its industry peers.[30] During the presentation, FRB delineated its approach of targeting affluent clientele and stated its median single-family home loan borrower had access to cash of

US$685,000, significantly higher than the national average.[31] FRB also openly acknowledged its practice of enticing wealthy customers with preferential loan rates.[32]

Through its innovative business model, FRB's assets increased roughly ten-fold from 2011 after its IPO to 2022.[33] FRB aimed to provide clients with specific financial products such as lines of credit or asset finance but also actively sought to address their broader financial well-being, with services such as mortgage lending and wealth management.[34] However, the unique business model and the nature of FRB's target clientele made it challenging to assess the bank's risks accurately.[35]

FRB's primary source of income was net interest income generated from loans and investment securities, with a considerable portion of its investments locked into real estate loans and municipal securities that offered lower liquidity and less competitive interest rates.[36] As of December 2022, FRB had the highest ratio of loans and securities relative to uninsured deposits among midsize banks.[37]

Depositors began withdrawing their bank deposits in pursuit of higher interest rates elsewhere, with a substantial portion of these deposits being uninsured, exceeding the FDIC's US$250,000 guarantee threshold.[38] The focus on high-net-worth individuals resulted in substantial cash balances, which were more easily transferable.[39] As a result, FRB's business model rendered it vulnerable to both an increase in interest rates and a bank run, both of which ultimately transpired.[40]

Figure 3 sets out FRB's financial performance from FY2018 to FY2022.

Figure 3: Historical financial performance of FRB[41,42]

(US$ in million, save for EPS indicators in US$)	FY'18	FY'19	FY'20	FY'21	FY'22
Interest income	3,032	3,579	3,853	4,385	5,722
Interest expense	530	815	591	271	888
Net interest income	2,501	2,764	3,262	4,114	4,834
Provision for credit losses	76	62	157	59	107
Net interest income after provision for credit losses	2,425	2,702	3,105	4,055	4,727
Net Income	854	930	1,064	1,478	1,665
Basic EPS	4.89	5.25	5.85	7.78	8.32
Diluted EPS	4.81	5.20	5.81	7.68	8.25

Source: First Republic Bank. (2023). Annual Report 2020 & 2022.

Fears escalate

"Standing alone, First Republic isn't presenting a systemic risk."

– Joe Lynyak, Partner at Dorsey & Whitney[43]

Throughout 2021, central bank officials held the opinion that inflation was a temporary evil of the COVID-19 recovery.[44] However, over time, Fed leaders recognised the inaccuracy of this assessment, prompting them to initiate rate hikes in March 2022.[45] Despite the commencement of rate increases, inflation persisted and continued to rise.[46]

Factors contributing to the SVB collapse in March 2023 exerted pressure on the banking system, contributing to the liquidity crunch which affected several other regional lenders.[47] These factors include the aggressive raising of interest rates by the Fed in 2022 which caused the value of SVB's treasury bonds and mortgage bonds to drop, adversely impacting SVB's balance sheet.[48] The worry among uninsured depositors also presented a tangible concern, given that SVB catered to a relatively focused demographic of tech startups and venture firms, a significant portion of which held uninsured deposits.[49] Known for its focus on providing long-term mortgage loans to affluent homebuyers, FRB faced similar exposure to elevated interest rates and concerns among depositors holding large amounts of uninsured deposits.[50] Despite a US$30 billion influx of deposits from the 11 largest US banks in March 2023, FRB continued to face speculation regarding its liquidity of lack thereof.[51]

Cozy relationship with auditor?

On 24 April 2023, FRB was sued by shareholders who alleged that the beleaguered US regional bank concealed how rising interest rates threatened its business model by prompting an exodus of deposits. The lawsuit, filed in San Francisco federal court, accused FRB and its auditor KPMG of misrepresenting the bank's balance sheet and liquidity.[52] It was filed three hours after FRB disclosed that it had lost US$102 billion, which accounted for 58% of its total deposits in the first quarter.[53] This figure excludes a temporary US$30 billion deposit infusion from the nation's largest banks.[54] In addition, FRB announced its intentions to reduce its workforce by up to 25%.[55]

In FRB's 2020 annual report, KPMG signed off on the audit and certified the bank's financial statements.[56] However, KPMG's certification was alleged to have understated the potential dangers and magnitude of the threats that FRB might face due to possible interest rate hikes, shifts in deposit composition, and the subsequent withdrawal of deposits.[57] KPMG had also issued clean audit opinions for Signature Bank and SVB, and faced another lawsuit on April 7 from three additional pension funds, due to the collapse of the bank.[58]

FRB had a longstanding relationship with KPMG, dating back to 1989.[59] Although officially appointed as its auditor since 2010, KPMG's role in auditing FRB's financial records extended from 1989 to 2007, prior to FRB's ownership by Merrill Lynch.[60] Similarly, KPMG also had a lengthy audit relationship with Signature Bank, which collapsed too.[61]

Where's the risk monitoring?

FRB's Asset Liability Management Committee (ALMCO) was responsible for overseeing interest rate risk and reporting breaches of thresholds defined in the Risk Appetite Statement to the Treasury Risk Officer, who determined if further reporting to the Bank Enterprise Risk Management Committee (BERM) or the Directors' Enterprise Risk Management Committee (DERM) was necessary.[62] BERM conducted quarterly reviews of interest rate risk information and reported any breaches to DERM. DERM, a committee of the board of directors (board) with delegated authority, approved risk limits for the bank, conducted quarterly reviews of interest rate risk information, and informed the board about significant matters related to interest rate risk.[63]

Economic value-based methodologies, such as economic value of equity (EVE), were utilised to measure how the economic values of the institution's position changed under various interest rate scenarios.[64] Risk tolerance and risk appetite breaches associated with EVE projections were identified by FRB starting in the second quarter of 2022.[65] In its August 2022 meeting, ALMCO unanimously approved taking no further action on the EVE risk profile breaches. The breaches were discussed by BERM in August 2022, and by DERM and the board in September 2022.[66] According to the meeting minutes, BERM, DERM, and the board agreed with ALMCO's decision to take no further action and continue to monitor the breaches.[67]

FRB identified further risk tolerance and risk appetite breaches associated with the EVE projections in the third and fourth quarter of 2022.[68] In October 2022, ALMCO discussed the breaches from September 2022 and once again unanimously approved taking no further action on the EVE risk profile breaches.[69] Subsequently, in November 2022, BERM, DERM, and the board discussed the breaches and agreed with ALMCO's decision to take no further action and continue to monitor the breaches. The breaches from December 2022 were presented to ALMCO, BERM, DERM, and the board in February 2023, but the meeting minutes were not finalised before FRB failed.[70]

Later discussions revealed FDIC officials expressing concerns about FRB's perceived lack of urgency in responding to the EVE breaches and equity value projections.[71] FDIC officials indicated that bank management and the board should have reacted more promptly and taken action to improve the bank's equity position.[72] This was only uncovered later as FDIC examiners only became aware in November 2022 that FRB's board had agreed with bank management's recommendation not to act in response to the interest rate risk scenario breaches.[73]

Where's the risk expertise?

FRB's DERM oversaw the company's overall risk profile and risk appetite.[74] Its main purpose was to "identify, assess, measure, monitor, report and control the core risks facing the Bank".[75] The committee had three board members and one special advisor at the time of its collapse.[76] According to FRB's Proxy Statement for 2022, all three board members were determined to be independent directors.[77] The special advisor, Willis H. Newton Jr., was the Chief Financial Officer (CFO) of FRB from 1988 to 2014 and was previously a senior audit manager at KPMG.[78]

All three board members sitting on DERM did not have specific risk management background in the banking and finance industry.[79] The Chair of DERM was 65-year-old Doctor of Medicine Sandra R. Hernandez (Dr. Hernandez). Dr Hernandez also serves as the President and Chief Executive Officer (CEO) of the California Health Care Foundation (CHCF), an independent foundation dedicated to improving the health of the people of California. Prior to joining CHCF, she was the CEO of The San Francisco Foundation and served as director of public health for the City and Country of San Francisco. Dr Hernandez was said by the bank to have experience leading organisations as a CEO, knowledge of cybersecurity risks, and extensive knowledge of the communities in which FRB operates.[80]

Another member of DERM was 51-year-old Professor Boris Groysberg (Professor Groysberg). He is a Professor of Business Administration, Organisational Behaviour at Harvard Business School. Additionally, he also sits on the board of BrightStar Group Holdings Inc, a healthcare company. Professor Groysberg has extensive teaching, research, and publishing experience in organisational behavior, talent management, and corporate culture.[81]

The third member was 40-year-old Shilla Kim-Parker (Kim-Parker). She is the CEO and co-founder of Thrilling, a venture-backed, digital marketplace. Kim-Parker has experience leading organisations, extensive digital and technology experience, and corporate governance knowledge.[82]

Old but wise Audit Committee?

FRB's Audit Committee (AC) oversaw the review of financial reporting and accounting processes. The AC Charter specifies that the committee's responsibilities include monitoring the integrity of FRB's financial statements and to be an avenue of communication between the auditors and the board.[83]

The committee had four board members at the time of its collapse, with two directors, George G. Parker (Parker) and Duncan Niederauer (Niederauer), recognised as AC financial experts as defined in Item 407(d) of Regulation S-K under the US Securities Exchange Act of 1934.[84]

Parker, who was 84 years old, served as the Chair of AC. He has extensive experience as a director, including serving as Chair of the AC for five separate public companies. Parker formerly served on the board of six exchange-listed public companies. He was a director for Colony Financial Corporation, Threshold Pharmaceuticals, and California Casualty Insurance Group during FRB's collapse.[85]

Meanwhile, Katherine August-deWilde (August-deWilde), who was 75 years old, served as the member of AC. She was an executive at FRB from 1985 to 2015, where she served as the President from 2007 to 2015 and the Chief Operating Officer from 1996 to 2014. She has taken on directorships on the boards of several public companies including TriNet Group, Inc., Eventbrite, Inc., and Sunrun, Inc. She also serves on the private company board of OpenGov, Inc. August-deWilde has extensive experience in the banking industry.[86]

Another member was 77-year-old Reynold Levy (Levy). He serves as a consultant to commercial and nonprofit institutions and as a senior advisor for East Rock Capital. He is also a member of the Council on Foreign Relations, on the Board of Overseers of the International Rescue Committee, and on the Board of Advisors of the Center for Ballet and the Arts at New York University.[87]

The last member was 63-year-old Niederauer. His prior experiences include serving as CEO of the NYSE and as a partner at Goldman Sachs. He co-founded Transcend Capital Advisors, an independent investment advisory firm. Niederauer is also a director of Realogy Holdings Corp. and sits on several additional boards, including the Bob Woodruff Foundation and Venezia FC.[88]

Given the failure to mitigate the risk and audit lapses, the Fed questioned the involvement of the committees.[89] The Corporate Governance Institute (CGI) recommends that board members streamline their corporate responsibilities to better fulfill their directorial duties as overboarding can be detrimental.[90] FRB's AC and Risk Committee (RC) comprised of members who hold more positions than CGI's recommended upper limit of four directorships.[91]

Introducing FRB's board

On 1 November 2023, the FDIC announced that they were investigating "potential misconduct by executives and board members of FRB."[92]

The FDIC highlighted that the FRB directors had failed to plan for an increase in interest rates despite warning signs.[93] In 2022, before the bank collapsed, the bank's risk models signaled issues but the board had decided "to take no further action".[94] The FDIC claimed that the board showed a lack of urgency in addressing the growing possibility of sharply increasing interest rates and its impact on the bank, contributing to FRB's collapse.[95]

Under US federal law, if the directors or officers of a company are found to be in breach of their fiduciary duty of care to the company, they are liable to fines or being banned from serving as directors for other companies.[96] The FDIC investigation is standard practice in the case of bank failures and does not necessarily indicate that the directors had breached their duties.[97]

Does size matter?

In 2012, the Association of Chartered Certified Accountants (ACCA) released a report finding that financial risk-taking is lower in boards that have fewer than eight directors.[98] Other studies also suggest that a leaner board size can have positive implications for the company.[99] Smaller boards (average around 9.5 members) have been found to outperform their peers by 8.5%, are associated with faster decision making, and have more effective oversight over management.[100,101] FRB had 12 directors at the time of its collapse, excluding one director emeritus.[102,103]

On the flip side, banks are subject to much more regulatory concerns compared to other companies.[104] They may therefore t require larger boards and more board committees for additional advice and expertise on regulatory matters.[105] Additionally, a study investigating a sample of 174 banks over 1995 to 2002 found that increasing the number of directors in banking firms did not reduce bank performance and could actually improve it.[106] The top three banks in the US by total assets are JPMorgan Chase (JPM), Bank of America, and Citigroup, which have 11, 13, and 13 directors respectively.[107,108,109,110]

Long serving "independent" directors

The NYSE listing standards, which FRB was subjected to, focuses on the material financial relationship between the director and the company when determining if a director is independent.[111] The listing standards do not consider tenure when determining independence of non-executive independent directors,[112] which FRB also did not consider.[113] Prior to the addition of new board members in 2022, five out of the eight (over 60%) non-executive directors for FRB had served for more than a decade at the time of its collapse.[114] In contrast, JPM only has three out of their eleven (27%) non-executive directors serving for more than a decade.[115]

Levy, the lead independent director for FRB, was appointed in 2013, just short of a decade before FRB's collapse.[116] According to FRB's Proxy Statement for 2022, Levy and the long-serving directors were determined by the company to be independent.[117]

Executive compensation

FRB collapsed before it released its Schedule 14A Proxy Statement for 2023. Hence, there was no official document listing director compensation for FRB for the year ended 2022.[118] However, according to FRB's Proxy Statement for 2022, a significant amount of compensation for both executive and non-executive directors came from restricted stock units (RSUs).[119] The explanatory statement accompanying the 2022 Proxy Statement highlighted that "In 2021, 93% of all compensation for all [named executive officers (NEOs)] was variable and contingent upon the Bank's financial, operational and strategic performance".[120] NEOs are the named executive officers of FRB and includes C-suite executives and former CEOs of the company.[121]

Insider trading?

> "Captains go down with the ship, but not these guys at First Republic, Silicon Valley Bank, and Signature Bank."
>
> – *Timothy Noah, Journalist of The New Republic*[122]

Months before FRB had collapsed and its share price plummeted, top executives of the bank reportedly sold company stock worth millions of dollars.[123] The portion of shares sold in those months by these executives were significantly larger compared to other time periods.[124]

James Herbert, founder, and Chair of the board, sold seven and five percent of his holdings in January and February respectively.[125] Robert Thornton, president of private wealth management, sold 73% of his holdings.[126] Michael Roffler, CEO, sold US$1.3 million worth of stock in November and US$1 million in January, a significant proportion compared to his previous sales in recent years.[127] David Lichtman, Chief Credit Officer, together with his spouse, sold US$5 million worth of shares in the five months before the collapse, the most they have sold at any time.[128]

These trades were reported to the FDIC and disclosed on FRB's website but were largely unnoticed by the public.[129,130] The market was found to be less likely to react to such insider sales reported to the FDIC when compared to filings reported with the Securities Exchange Commission (SEC).[131] In March 2023, FRB was the only company in the S&P 500 index that did not file their insider trades with the SEC.[132]

Sehwa Kim, an accounting professor at Columbia Business School, noted that banks that did not file their insider trades with the SEC were found to have executives who were more likely to engage in selling of shares ahead of negative news.[133]

Additionally, none of the executives' sale of shares was executed under SEC Rule 10b5-1 plans, which are pre-scheduled sales.[134] These plans are designed to allow company insiders to create a predetermined plan to sell company stocks at a specified price, amount, and date to prevent accusations of insider trading.[135] The trades came under scrutiny and federal regulators are investigating certain FRB executives for potential insider trading.[136] As of 25 February 2024, the status of these investigations remains unknown.

US regulatory environment

US laws and regulations pertaining to corporate governance are divided between state and federal. Businesses are required to comply with US federal law which applies to every individual and entity unless otherwise exempted, and the laws of the state where they are incorporated. Typically, this is governed by the Delaware General Corporation Law as most US companies choose to incorporate in Delaware due to its tax exemption benefits and the business-friendly environment provided by Delaware's Courts.[137]

US laws relevant to corporate governance include the Delaware General Corporation Law, the US Securities Act, the Dodd-Frank Act, the Sarbanes-Oxley Act, and the relevant stock exchange listing rules. Corporate governance in the US is also influenced by numerous guidelines or "best practices" set forth by non-government entities, institutional investors, and stakeholder litigation with contingency fee arrangements.

To code or not to code?

The Fed, through its Basel Committee on Banking Supervision, has issued the Basel Committee's Revised Principles, a non-mandatory and non-legally binding framework, which serves as a Code of Corporate Governance for banks.[138] Furthermore, there are numerous guidelines or "best practices" by other non-government entities such as the American Law Institute's Principles of Corporate Governance, the National Association of Corporate Directors' Key Agreed Principles, and the Business Roundtable's Principles of Corporate Governance. All of these are similarly non-legally binding or mandatory but are recommended as frameworks for directors to adopt for their own corporate governance policies at their own discretion.

While the various US corporate governance guidelines are neither mandatory nor legally binding, companies must still adopt and disclose their own corporate governance guidelines. Additionally, they are required to address several issues prescribed by the stock exchange such as executive compensation, their associated responsibilities, and executive qualification standards, amongst others, pursuant to the NYSE Listing Rules Section 303A.09.[139] Certain aspects of corporate governance are also mandated by legislation. For instance, Section 302 of the Sarbanes-Oxley Act, titled Corporate Responsibility for Financial Reports, mandates a company's CEO and CFO personally certify that all records are complete and accurate.[140]

Stock exchange listing rules

The NYSE and NASDAQ list several rules or conditions that current and prospective companies must agree to be bound by in order to be listed on their stock exchange. The relevant provisions of corporate governance are found in NYSE Listing Rules Section 303A and in the 5600 series of the NASDAQ rulebook. While both stock exchanges have similar provisions which entails independence of directors, the various board committees such as the Compensation Committee, AC, and Nominating Committee (NC), have several differences which demonstrates that listing on the NYSE is more stringent than on NASDAQ.[141]

While both stock exchanges prescribe their own definitions and determinants of independence of directors and require the listed entity to declare their director's independence, the NYSE further requires disclosure of the basis for determining such independence, pursuant to NYSE Listing Rules Section 303A.02.[142] In contrast, there is no equivalent disclosure required by NASDAQ.[143]

Regarding NCs, the NYSE has a stricter requirement to be composed of only independent directors, pursuant to NYSE Listing Rules Section 303A.04(a).[144] Meanwhile, NASDAQ allows some flexibility for the NC to be comprised of either only independent directors or at least a majority of independent directors, pursuant to NASDAQ Rulebook Section 5605-6(e)(1). [145]

Moreover, the NYSE specifically mandates listed companies to have an internal audit function, pursuant to NYSE Listing Rules Section 303A.07(c), with the purpose of providing management and the AC with assessments of risk and internal control.[146] In contrast, NASDAQ has no requirement for listed companies to have an internal audit function.[147, 148]

Notwithstanding these differences, rules by both stock exchanges are enforced by various disciplinary actions from the stock exchanges such as public remand, suspensions of trading or even permanent delisting from the stock exchanges.[149]

Institutional investors

Institutional investors such as banks, hedge funds, pension funds, and insurance companies trade on a significantly larger basis as opposed to individual or retail investors.[150] As such, institutional investors often hold consolidated shares or voting powers of companies on behalf of their individual clients, acting as if there were a shareholder's agreement to perform block voting on shareholders' resolutions.[151]

In the US, there are also proxy advisory firms.[152] These firms offer advisory services to allow their individual clients to make more informed decisions with the shares they hold.[153] Such advice or guidance can have significant influence on a company, since shareholders may rely on these guidelines given the independence of these firms from the company.[154] Recommendations from such services have "bite and teeth" as the recommendation to shareholders to withhold their votes has been found to cause a reduction in favourable voting.[155] As such, proxy advisory firms are integral to the US system of corporate governance, as their proxy advisory services may exert pressure on directors to yield to stronger shareholders resolutions.

Dodd-Frank Act – Safety on

The Dodd-Frank Act stands out as the most significant and applicable legislation that contributed to FRB's failure. Enacted in response to the 2008 financial crisis, this federal law introduced various provisions aimed at bolstering the safety of the US financial system and curbing excessively risky practices such as those involving derivatives and mortgages.[156]

Pursuant to the Dodd-Frank Act Section 171, institutions must abide by capital requirements imposed to ensure sufficient liquidity and to stay solvent particularly during financial stress events.[157] Annually, the Fed conducts stress tests and sets capital requirements for large banks according to the results of these assessments. These capital requirements are standardised regulations mandating the amount of liquid capital that banks and other depository institutions must hold relative to a certain level of their assets.[158]

The objective of these capital requirements is to mitigate the risk of default by ensuring that banks' investments are not overly speculative and that they maintain sufficient capital to absorb operating losses while still honoring customer deposit withdrawals.[159] Banks failing to meet the minimum capital requirement face automatic restrictions on capital distributions and bonus payments. Each bank's board is principally responsible for ensuring that their capital allocation adheres to the prescribed regulatory requirements and suits the bank's operational needs.[160]

Initially, section 171 imposed a qualifying criterion based on a threshold of US$50 billion. This meant that institutions with assets exceeding this threshold were considered "too big to fail" or interconnected, with their potential failures posing significant risks to the US economy.[161] Hence, many institutions, including FRB were subject to the stringent provisions of the Dodd-Frank Act due to their assets surpassing the US$50 billion threshold at the time.[162]

Crapo Bill – Safety off

The Economic Growth, Regulatory Relief and Consumer Protection Act, colloquially known as the Crapo Bill, was enacted to strike some balance from the onerous provisions in the Dodd-Frank Act. One significant change included raising the threshold from US$50 billion to US$250 billion, effectively reducing the number of banks subject to Dodd-Frank Act to less than half the initial number, which included FRB.[163]

Consequently, FRB was no longer subject to the Dodd-Frank Act's company-run stress testing requirements or the Market Risk Capital Rule.[164] These stress tests were designed to assess the potential impact of economic or financial shocks on banks' risks and capital reserves. Despite being exempted from these regulations, FRB asserted that it continued to conduct internal capital stress tests as part of its normal operations and was sufficiently liquid, as evidenced by its balance sheet and disclosures.[165]

However, US senator Chris Dodd, who sponsored the Dodd-Frank Act, opposed the Crapo Bill due to concerns about the increased asset threshold. He feared that raising the threshold to US$250 billion would heighten risks and diminish oversight, leaving only a few large banks subject to regulatory scrutiny while allowing medium-sized banks like FRB to evade supervision and compliance.[166]

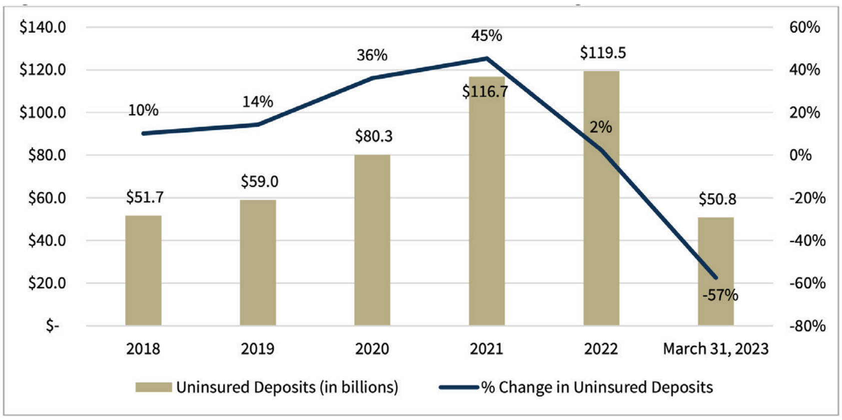
Bank oversight or OVERSIGHT?

As FRB was no longer subjected to the onerous provisions of Dodd-Frank Act due to the increased asset threshold introduced by the Crapo Bill, the bank was thus free from the heavy oversight, scrutiny, and supervision of the Fed. However, this reduced oversight became problematic when a substantial proportion of FRB's deposits exceeded the FDIC's US$250,000 limit for coverage per account holder and per account type. Any excess above this amount was neither covered nor insured, meaning that depositors were essentially bearing full risk of the losses exceeding the limit.[167]

FRB's reliance on uninsured deposits represented a funding concentration and primarily a volatile source of funds after the failure of SVB. The FDIC observed that deposit relationships may remain stable notwithstanding exceeding the US$250,000 limit under favorable positions. However, these deposit relationships may erode to become less stable when institutions find themselves in unfavourable positions such as when interest rates climb significantly or quickly.[168]

FRB's uninsured deposit balances doubled from the end of 2019 to the end of 2021 as shown in Figure 4. This can be attributed to FRB's clients holding larger liquidity positions juxtaposed to the pre-pandemic economic conditions. Furthermore, deposits grew due to FRB's relationship-based business model and its exemplary services continued to attract high net worth clients and their associated businesses with large balances.[169]

Figure 4: FRB's uninsured deposit growth from 2018 to 2023[170]



Source: Federal Deposit Insurance Corporation. (2023, September 8). FDIC's supervision of First Republic Bank. FDIC.

Despite the growing number of uninsured deposits, FRB monitored the stability of these accounts via several methods such as key risk indicators, risk dashboards, and direct communication between FRB's executives and clients holding substantial deposits. Among these methods, the risk dashboard provided a holistic assessment of deposit stability every quarter which included surveys that measured client loyalty, providing FRB a reasonable basis and confidence that a bank run was unlikely to occur.[171]

Self-monitoring

The FDIC assigned a dedicated examination team and over the years. FRB was reported to have scored well in the various tests prescribed by the FDIC despite the increased growth of uninsured deposits.[172] The FDIC further opined that FRB was responsive to its recommendations and implemented corrective actions hastily.[173] Furthermore, there was a noticeable downtrend in supervisory recommendations post 2018, which illustrates the impact of easing regulatory supervision due to the introduction of the Crapo Bill, which allowed FRB to be subject to fewer regulations.

With regards to FRB's liquidity, particularly considering the increasing number of uninsured deposits, the FDIC gave an extremely generous liquidity rating of one and two. These ratings indicate that the FDIC believed FRB had strong and satisfactory liquidity levels, which, in hindsight, was revealed to be too generous due to FRB's high levels of uninsured debts.[174]

FED-up with regulators?

Apart from the FDIC and FRB, the Fed was also arguably involved in FRB's failure. As regulator, the Fed had access to all the public information and resources necessary to conduct sufficiently appropriate due diligence on FRB's growing uninsured deposits. Additionally, the Fed serves as the central entity responsible for raising interest rates in the US, which had a detrimental impact on FRB's business model.[175]

Furthermore, pursuant to the Crapo Bill Section 401, the Fed had the discretion to impose the same restrictions on FRB as on the big banks, particularly those with assets exceeding US$250 billion, once FRB's assets exceeded US$100 billion. This would subject FRB to higher scrutiny, supervision, and oversight. Given the Fed's authority over interest rates and its awareness of the sensitivity of FRB's business model to rising interest rates, this intervention could have been crucial.[176, 177]

Third time's the charm

JPM acquired most of the assets and specific liabilities of FRB from FDIC following FRB's collapse. The assets include approximately US$173 billion in loans and US$30 billion in securities, while the liabilities include approximately US$92 billion in deposits and loss share agreements including mortgage and commercial loans. However, JPM will not assume FRB's corporate debt or preferred stock.[178]

FRB was able to effectively resume operations on 1 May 2023, the same day it was reported to be acquired by JPM. This ensured uninterrupted service to FRB's clients and transition plans are underway to integrate FRB into JPM's ecosystem.

JPM's Chairman and CEO, Jamie Dimon, proclaimed that the acquisition has benefitted both the US government and JPM, paving the way for JPM to further advance their wealth strategy while saving FRB and the FDIC.[179]

> "This part of the crisis is over."
>
> – *Jamie Dimon, Chairman and CEO of JPMorgan Chase*[180]

Discussion questions

1. What factors contributed to the collapse of First Republic Bank. Rank them in order of importance and explain your ranking.
2. Assess the composition of FRB's board, Directors' Enterprise Risk Management Committee and Audit Committee, and the actions of the directors. To what extent do you think they may have contributed to the collapse of First Republic Bank. Explain.
3. How do regulatory authorities in Singapore and the United States differ in their criteria for assessing the independence of directors? What other factors could be considered when evaluating the independence of a director? Explain.
4. What risk management measures could have been implemented by FRB in light of the high interest rate environment? Frame your response with reference to the four lines of defense framework.
5. Discuss the degree of accountability that should be attributed to KPMG for FRB's failure.
6. Critically evaluate the remuneration policies of FRB. To what extent do you think that this may have contributed to the bank's collapse?
7. Considering the Federal Reserve's (Fed) interest rate adjustments and the complex structure of First Republic Bank's (FRB) internal risk monitoring controls, to what extent can we attribute the perceived shortcomings of the Fed to the bank's own management decisions and operational practices?
8. Given the collapse of FRB and the FDIC's admission of oversight lapses, particularly regarding high levels of uninsured deposits and vulnerability to interest rate changes, should the US reconsider its stance on granting large banks like FRB exemptions from Fed oversight? If exemptions are to continue, what specific mitigating measures should the Fed implement to ensure financial stability and prevent similar collapses?
9. Compare and contrast the corporate governance regulatory framework for banks and listed companies in the US compared to your country. What are the pros and cons of the differences in approach?

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FTX: FALL OF A CRYPTO GIANT

Case overview

FTX Trading Ltd. (FTX), once the world's second-largest cryptocurrency (crypto) exchange, collapsed on 11 November 2022. The downfall began on 2 November 2022 when CoinDesk, a popular crypto news site, published an article exposing FTX's shady business dealings. This led customers to begin withdrawing their funds, triggering a modern-day bank run in the crypto world. Only a fortunate few managed to withdraw their money in time. Others were informed that their withdrawal requests would be slowed or halted due to illiquidity. FTX did not have enough assets to meet these demands and was forced to declare bankruptcy, leading to the loss of billions of dollars.

The objective of this case study is to facilitate a discussion of issues such as factors contributing to the collapse of the world's second-largest crypto exchange; experience and competencies of management; corporate governance of crypto firms; ethics; risk management; investors' due diligence; external audits; cross-border regulatory issues; regulation of crypto firms; and role of the media in promoting good corporate governance and transparency.

FTX

Founded in May 2019 by Sam Bankman-Fried (SBF) and Gary Wang (Wang),[1] FTX Trading Ltd. (FTX) was often mistakenly regarded as the sole entity running the now-defunct cryptocurrency exchange. In reality, FTX's operated within a complex, web-like organisational structure designed by SBF, encompassing over 100 interrelated entities managed by approximately 300 employees across 27 regions.[2,3]

Incorporated in Antigua and Barbuda and headquartered in the Bahamas,[4] FTX oversaw global offshore operations outside the United States (US) through the domain FTX.com. This is the domain name most people associate with FTX.[5] In contrast, US operations were managed by West Realm Shires Services Inc. (West Realm), operating as FTX US under the domain FTX.us. West Realm was founded in January 2020 to serve US customers wanting to trade on the exchange.[6]

FTX offered a variety of trading products, including derivatives, options, volatility products, leveraged tokens, and Non-Fungible Tokens (NFTs). It also provided spot markets in over 300 cryptocurrencies trading pairs,

This case study was originally prepared by Andrea Low Yixi, Or Hiu Kwan Catherine, Teddy Zhuang Ziheng, and Yong Wei Jian, Martin. It has been edited by Ronn Chiew Wee Meng and Koh Yan Qi, under the supervision of Professor Mak Yuen Teen, with additional content added. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees.

including commonly traded cryptocurrencies and its native FTX Token (FTT). These services were available to both retail and institutional traders.[7]

FTX generated revenue through several operations. Primarily, it earned from trading fees charged to users for transactions made on its platform. Additionally, FTX offered loans to users who met specific criteria, earning interest revenue from these loans. FTX also issued Visa debit cards to approved platform applicants from eligible regions, charging an interchange fee on every transaction, which was then split between the card provider, Visa, and FTX. Furthermore, FTX allowed users to trade NFTs through its NFT marketplace which was launched in October 2021. The company collected a fee for each NFT transaction. Lastly, FTX invested in equities and tokens of other cryptocurrency and blockchain startups via FTX Ventures, its venture capital operations. These investments provided FTX with passive income from capital gains.[8,9]

Alameda Research

Besides FTX and West Realm, there was Alameda Research LLC. (Alameda), a quantitative cryptocurrency trading firm founded in October 2017 by SBF and Tara Mac Aulay (Mac Aulay).[10] However, Mac Aulay left in April 2018, citing reasons "due to concerns over management and business ethics".[11] Despite its separate entity status, Alameda played a significant role in FTX's business operations and growth. Initially, its aim was to execute market-neutral trades, exploiting arbitrage prices. This involved buying cryptocurrencies at lower prices in one market and selling them at higher price in another market for a small but quick profit.[12] As cryptocurrency adoption increased, the price gaps between markets narrowed, prompting Alameda to explore other revenue avenues. Eventually, it turned to leveraged directional trades, using borrowed funds to heavily bet on the market movements.[13]

A financial rollercoaster

FTX's revenue experienced a significant surge from its inception, growing by over 1000% from 2020 to 2021. According to CNBC, leaked financial documents from FTX revealed a net income of US$388 million in 2021.[14] SBF repeatedly emphasised the profitability of both FTX and Alameda. However, a court motion uncovered that the entities' tax returns in 2021 showed a collective net loss of US$3.7 billion since the beginning of their operations.[15]

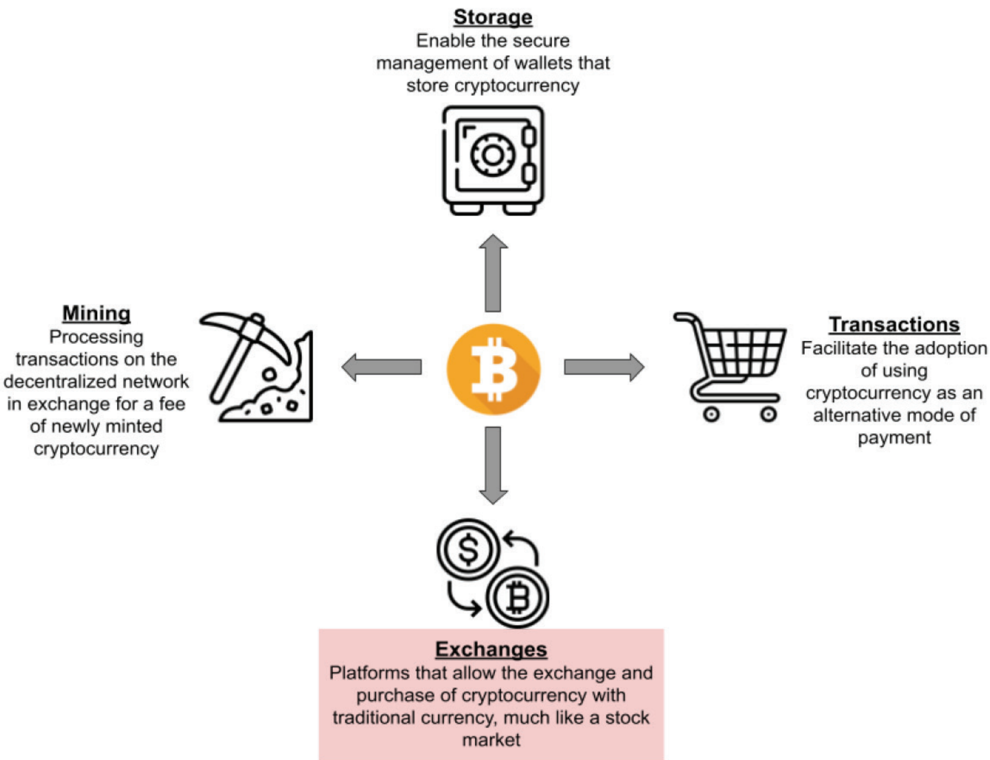
Diving into FTX

Cryptocurrency, a digital form of currency, aims to facilitate speedy, reliable, and transparent transactions using blockchain technology. Operating on a peer-to-peer system, it seeks to eliminate intermediaries such as banks and financial institutions, allowing transfers to be made directly between individuals.[16] Cryptocurrency is a broad term encompassing thousands of digital currencies available on the blockchain, including notable names such as Bitcoin, Ethereum, and Litecoin.[17]

FTX served as a centralised cryptocurrency exchange platform, acting as a bridge between users and the cryptocurrency world. Customers could deposit and withdraw funds via their bank accounts or credit cards, using these funds to purchase cryptocurrency on the exchange.[18] These purchases could then be transferred to customers' external crypto wallet address for storage or transacting with other users. The other centralised exchanges, Binance and Coinbase, ranked first and second respectively in terms of trading volume, following the collapse of FTX. Despite the decentralised nature of cryptocurrency, the majority of transactions between users are still facilitated through centralised systems due to the need for liquidity.[19]

Figure 1 shows the cryptocurrency ecosystem.

Figure 1: Cryptocurrency ecosystem chart[20]



Source: Rauchs, M., Blandin, A., Klein, K., Pieters, G. C., Recanatini, M., & Zhang, B. Z. (2018, December 12). 2nd global cryptoasset benchmarking study.

The unravelling of FTX

The downward spiral for FTX began on 2 November 2022, when CoinDesk published an article exposing leaked financial information of Alameda, which revealed that a significant portion of Alameda's assets consisted of FTT, a native token of FTX. Transactions made using FTT offered users discounts on trading fees, which increased its demand among FTX's investors. Consequently, its value surged, prompting Alameda to utilise its FTT holdings as collateral for loans from creditors to support its trading activities.[21] However, the fact that Alameda held a substantial number of tokens beyond what was actively traded in the market raised concerns about the ease of liquidating FTT at current prices.[22] This increased apprehension regarding the volatility of FTT and the financial stability of Alameda and FTX.[23]

Following this exposure, on 6 November 2022, Changpeng Zhao (Zhao), CEO of Binance, announced the sale of Binance's entire holdings in FTT, valued at approximately US$580 million.[24] Almost immediately after the announcement, Alameda's CEO Caroline Ellison (Ellison), offered to purchase Binance's FTT holdings at the market price of US$22 per token. This decision led to speculation that Alameda's loans would face liquidation if FTT's value dipped below the current market price.[25] Binance's decision triggered a liquidity crisis for FTX and sparked panic among FTX's investors, triggering an estimated US$6 billion in withdrawals in a mere three days, akin to a bank run.[26] With insufficient funds to meet withdrawal demands, FTX halted customer withdrawals entirely.[27]

On 7 November 2023, SBF responded to the turmoil with a series of tweets, affirming: "A competitor is trying to go after us with false rumours. FTX is fine. Assets are fine. FTX has enough to cover all client holdings. We don't invest client assets (even in treasuries)."[28]

Following FTX's move to halt withdrawals, media organisations including Bloomberg, the Financial Times, and the Wall Street Journal cited anonymous sources claiming that FTX needed US$8 billion to bridge the gap between what it owned and what it could pay out.[29] In an interview with a VOX journalist via Direct Message (DM) on Twitter, SBF disclosed the urgent need to raise $8 billion within two weeks to rectify the situation with account holders. He further mentioned that raising US$8 billion to compensate account holders was his top priority and was at that time, all that mattered for the rest of his life.[30]

On 8 November 2022, FTX and Binance reached a non-binding agreement for Binance to acquire FTX as the latter "asked for help"[31] due to "a significant liquidity crunch",[32] according to Zhao's tweet.[33] Following this announcement, FTT's value fell by 80%, resulting in a loss of over US$2 billion.[34]

Just a day later, Binance withdrew its acquisition offer after due diligence allegedly discovered huge gaps in FTX's books. To exacerbate matters, venture capital firm Sequoia Capital announced the write-down of its estimated US$210 million investment in FTX.[35] That same day, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) initiated investigations into FTX regarding its ties with Alameda and FTX US, as well as FTX's potential mishandling of investor funds.[36] Facing an US$8 billion shortfall, SBF sought to raise funds through debt or equity, or both, to prevent bankruptcy.[37] Meanwhile, users attempting to log in encountered malfunctioning issues on FTX's website.[38]

On 10 November 2022, SBF announced the shutdown of Alameda, while FTX US declared a trading halt.[39] FTX's assets were frozen by regulators in the Bahamas, with the Securities Commission of Bahamas (SCB) seeking a provisional liquidator for FTX. Concurrently, in a desperate attempt to save FTX, SBF sought to raise approximately US$9.4 billion from investors and competitors with no guarantee of success.[40]

On 11 November 2022, FTX, together with its subsidiaries and affiliated entities such as Alameda, started Chapter 11 bankruptcy proceedings.[41] That same day, SBF resigned from his position as CEO, with John J. Ray III (Ray), a lawyer specialising in restructuring distressed companies, appointed as the new CEO.[42]

Cyber hacks or embezzlement?

The next day, FTX transferred users' funds to offline wallets following a series of "unauthorised transfers"[43] siphoned off hundreds of millions of dollars from the beleaguered cryptocurrency exchange. Ryne Miller, the general counsel at FTX US, did not confirm a hack but said on Twitter that the company took this action to "mitigate damage"[44] caused by the potential theft.[45] Transferring funds to offline wallets, or "cold storage", helps prevents unauthorised access by external parties.[46] While FTX officials did not specify the amount of assets stolen, blockchain analytics firm Elliptic estimated that US$477 million was lost in the suspected theft.[47] CEO Ray advised FTX users to delete the company's app to mitigate risks and issues stemming by malware.[48]

In an interview with CoinDesk, Dyma Budorin (Budorin), the co-founder and CEO of blockchain security auditing company Hacken, stated that the hacker appeared to have "had access to all the cold wallet storages which he exploited."[49] The investigation revealed that the hacker attempted to send tether (USDT) stablecoin on the Tron blockchain multiple times but failed due to insufficient TRX (the native token of the Tron network) in the wallet to cover the transaction fees.[50] To complete the transaction, the hacker then transferred 500 TRX tokens to the hacked wallet using their verified personal Kraken account. Because of Kraken's "know-your-customer" (KYC) measures, which are part of the anti-money laundering compliance requirements and verification process, FTX was able to obtain information on the owner of the personal wallet from which the TRX was sent, exposing the hacker's identity.[51]

Despite appearing to be a typical cyberattack, many suspected it was an inside job, orchestrated by SBF, who allegedly provided the hacker with access to the "cold wallets". When asked if SBF owned the compromised wallet, Budorin refused to disclose this information, citing confidentiality.[52] The alleged "back door" in FTX's systems was the primary justification for this belief. According to Reuters and CNBC, FTX employees discovered that SBF had set up a "back door" in FTX's system for emergencies. This back door could be used to secretly remove funds from FTX's financial records, allowing SBF to withdraw any amount of money he needed without detection.[53]

Ray to rescue

Ray is best known for serving as the Chairman of Enron after its collapse, during which he recovered more than US$800 million for its creditors.[54] Ray's current role as the CEO and Chief Restructuring Officer of FTX involves guiding the company through its bankruptcy proceedings and helping creditors and customers recover as much of the missing funds as possible. He was paid US$1,300 per hour, amounting to US$690,000 over two months.[55] Six days after his appointment, Ray published a 30-page Chapter 11 filing report for FTX. This report highlighted issues such as fund misappropriation, lack of risk management, poor board governance, and other red flags.[56]

Behind the scenes

> "The FTX group's collapse appears to stem from absolute concentration of control in the hands of a small group of grossly inexperienced, non-sophisticated individuals."
>
> – *John J. Ray III, CEO of FTX*[57]

The frontman of FTX was founder and ex-CEO SBF. Before launching his career in trading, he studied at the Massachusetts Institute of Technology (MIT), where he obtained a Bachelor's Degree in Physics with a minor in Mathematics.[58] Upon graduation, he worked at Jane Street Capital (Jane Street), a renowned quantitative trading firm, where he traded equities and exchange-traded funds (ETFs). With a strong interest in "effective altruism", a philosophical movement that justifies accumulating great wealth to help others in need, SBF had a brief stint at the Centre for Effective Altruism after leaving Jane Street in 2017. He utilised his knowledge of arbitrage strategies to trade Bitcoin, a high-risk, high-reward cryptocurrency. This marked the beginning of his cryptocurrency journey. Later in 2017, he co-founded Alameda. Two years later, he established FTX.[59]

Next in line was Wang, the co-founder, and Chief Technology Officer of FTX and Alameda. Often described as "mysterious" and "a shady but critical player in the rise and fall of FTX",[60] Wang is an MIT alumnus with degrees in Mathematics and Computer Science. Before co-founding FTX, he worked at Google, where he developed a system to aggregate flight prices from public data. In 2017, he left Google to join Alameda with SBF, his childhood friend. Two years later, he co-founded FTX with SBF.[61]

Nishad Singh (Singh) served as the director of engineering at FTX.[62] Singh was an honours student at the University of California, Berkeley, majoring in Electrical Engineering and Computer Science.[63] After graduating, he joined Facebook as a software engineer but left after five months to join Alameda, inspired by Alameda's work culture.[64] He later became the director of engineering at Alameda before taking on the same role at FTX.[65]

Another figure at FTX was Constance Wang (Constance), a Singaporean who held the position of Chief Operating Officer (COO). Constance was a 2016 graduate from the National University of Singapore with a degree in Business Administration specialising in Finance. She joined Credit Suisse as a risk analyst upon graduation and later joined Huobi Global as a business development manager.[66] While working in institutional sales in Singapore, Constance met SBF, and according to her, they "clicked immediately."[67] This connection prompted her to move to Hong Kong in early 2019 to work on FTX with SBF as the company's COO.[68] Within FTX, Constance was appointed co-CEO of FTX Digital Markets, a subsidiary of FTX.[69] She has not been accused of any wrongdoing.[70]

They met while she was working in institutional sales in Singapore, and she moved to Hong Kong in early 2019 to work more closely with him on developing FTX.

Lastly, a key contributor to FTX's demise was Ellison, the CEO of Alameda, though she was not an FTX employee. Ellison is the child of MIT economists Glenn Ellison and Sara Fisher. She attended Stanford University and pursued a Bachelor's Degree in Mathematics. After graduation, she joined Jane Street as an equities trader, where she met SBF. In 2018, she left Jane Street for Alameda and was later appointed CEO.[71]

The blurred lines

Further scrutiny into the inner dealings of FTX revealed an entity with pervasive questionable and unlawful practices. FTX's issues partly stemmed from its complex leverage and margin trading practices. The "spot margin" feature allowed users to lend their assets to others, earning yield, but FTX subtracted borrowed assets from what it needed to keep in its wallets to match customer deposits. This meant assets were not backed one-to-one, leading to an underestimation of customer liabilities.[72]

Sources indicated that Alameda was at the heart of this activity, with SBF reportedly transferring US$10 billion of FTX's customer funds to Alameda to keep it afloat amidst a series of trade losses.[73] Alameda exploited this feature by borrowing customer funds essentially for free, using FTT tokens as collateral. These tokens retained their market value since they were not sold on the open market, allowing Alameda to borrow against them. FTX sustained this pattern by maintaining the FTT token price and avoiding mass customer withdrawals.[74] These related-party transactions were conducted covertly, hidden from investors, employees, and auditors until the bankruptcy proceedings. This concealment was possible as the traded assets never appeared on Alameda's balance sheets. Instead of holding money, Alameda quietly borrowed funds to trade.[75] According to US securities laws, it is illegal for FTX to handle and transfer customer funds to Alameda,[76] a practice forbidden by FTX's own terms of service.[77]

Ultimately, Alameda did not achieve much success with its trades. One of the losses Alameda faced involved a US$500 million loan agreement with crypto lender Voyager Digital, which was terminated when Voyager Digital subsequently filed for bankruptcy protection the following month.[78] The multiple trade losses incurred by Alameda were ultimately fatal for FTX, which did not possess sufficient customer funds on hand at the time of the crypto equivalent of a bank run.[79]

Subsequent findings revealed the existence of a "back door" in FTX's system, built with "bespoke software", which facilitated the undetectable mishandling of customer funds and secret transfers to Alameda.[80] The system, created by Wang at SBF's request, consisted of a single line of code within its complex systems. This "back door" had allowed Alameda to allegedly borrow up to US$65 billion in customer's funds, without their knowledge or consent.[81]

An anonymous party under the pseudonym "Yung Dot", who claimed to be a former employee of FTX, further revealed that the "back door" allowed SBF to "send fraudulent logger messages … back to auditors if they ever queried".[82] He added that his team had been retrenched after speaking out against the obscuring of transactions that propped up FTT and that the program his team had developed for FTX had been "used fraudulently with very little regard for [their] wishes".[83]

Black hole

Many may wonder how Alameda managed to lose all its investors' money. One hypothesis is that the young traders at Alameda, despite being previously ranked as one of the top cryptocurrency trading companies globally, lacked practical experience. When SBF, a well-recognised trader, founded Alameda in 2017, the focus was primarily on cryptocurrency price arbitrage. In 2019, however, he shifted his primary focus to launching his trading platform FTX.[84]

As Bitcoin gained traction in the fall of 2020, Alameda moved away from its initial focus on generating fast, market-neutral bets independent of predicting cryptocurrency movements. Some traders speculated that Alameda modified its tactics due to losing its competitive advantage as more experienced companies, such as Jump Crypto, expanded their cryptocurrency trading operations.[85]

Many of Alameda's long bets, based on predictions of a rise in prices, likely incurred significant losses starting in May 2022. The rapid collapse of Terra USD and its sister cryptocurrency Luna accelerated the downturn in the cryptocurrency market. SBF further admitted in a Twitter exchange with a VOX reporter that his company had amassed a large amount of "risky leverage"[86] around the time of Luna's crash.[87]

In addition to placing large bets, Alameda took on excessive leverage which amplified both gains and losses. One method the firm's executives employed was pledging loans as collateral for mostly illiquid cryptocurrencies, such as FTT. For instance, SBF was involved in the development of another cryptocurrency called Serum, which was made public in 2020. Initially, only 10% of the coins in circulation were openly tradeable, while the remaining 90% were locked up for many years.[88] On that basis, he estimated that if the Serum in circulation was worth US$1 billion, the market value of the total coin supply would be US$10 billion. This inflated valuation enabled him to apply for loans with greater ease.[89]

> "This is likely how Alameda/FTX incurred the multi-billion-dollar hole: Alameda pledging illiquid collateral to borrow money to finance bets, which got margin called as markets went down this year."
>
> – *Jason Choi, a crypto investor*[90]

Money trail

Following the collapse of FTX, much of the unaccounted funds were traced to SBF's personal account.[91] SBF, along with five members of his inner circle, transferred a total of US$3.2 billion into their personal accounts as "payments and loans" using funds primarily from Alameda. According to court fillings, SBF received about $2.2 billion, while Singh, Wang, and Ellison received $587 million, $246 million, and $6 million, respectively. SBF faced eight criminal changes, including money laundering and wire fraud, related to the downfall of FTX.[92] Meanwhile, FTX insiders Wang, Singh, and Ellison have pleaded guilty and are cooperating with prosecutors.[93]

A significant portion of the siphoned funds was used for political and charitable donations and luxury properties in the Bahamas. Between 2020 and 2022, official property records revealed that SBF, his parents, and senior executives of FTX purchased at least 19 properties in the Bahamas, worth nearly US$121 million.[94] It was also uncovered that one of FTX's units spent US$300 million in the Bahamas, buying homes and vacation properties for its senior staff. Property documents showed that seven condominiums in the upscale Albany were purchased for US$72 million to serve as a "residence for key personnel", although reports were unable to identify who lived in them.[95] Additionally, a "vacation home" with beach access in Old Fort Bay was purchased under SBF's parents' name. When questioned about the property purchase and its funding, a spokesman for the parents did not respond directly, stating only that they were attempting to return the property to FTX.[96]

The most expensive purchase was a US$30 million penthouse at the Albany, a resort where Tiger Woods hosts an annual golf tournament. Other costly purchases included three high-end condominiums at One Cable Beach and a beachfront residence in New Providence, totalling $2 million.[97]

Bribery or donations?

Since its bankruptcy, FTX's new management has been pressuring hundreds of politicians and political organisations to return millions of dollars donated by the previous management. Under US law, payments or transfers made within 90 days of bankruptcy are presumed to be preferential if they result in a creditor receiving more than it would have been entitled to at the end of the bankruptcy process, and a "clawback" can attempt to recover the difference in the payments. FTX said it reserves the right to sue the recipients if the donations are not repaid.[98]

From September 2020 to November 2022, SBF gave nearly US$80 million to political candidates as "donations".[99] As one of the largest political donors in American politics, he has been accused of illegally channelling millions of US dollars to political candidates and groups. These donations were customer money funded by Alameda, disguised to look like they were coming from affluent co-conspirators. The use of these illicit funds served SBF's ambition to buy "bipartisan influence" and impact the politics in Washington.[100] According to records from the Federal Election Commission, SBF's largest donations were US$27 million to his own political action committee (PAC) which supported Democratic candidates, and US$6 million to a PAC that helped elect Democrats to the US House. He further gave US$5,800 each to dozens of candidates, mostly Democrats. President Joe Biden's 2020 run for president was one of the major beneficiaries of SBF's donations – US$5 million was donated to a PAC that supported this campaign.[101]

In an interview with NBC News, SBF said that he had given the same amount to Republicans as well. However, US$40 million went unnoticed because all his Republican donations were allegedly "dark money".[102] The reason he provided was that "Reporters freak the f**k out if you donate to a Republican. They're all secretly liberal, and I didn't want to have that fight, so I made all the Republican ones dark".[103] However, this was impossible to verify since the donations could not be traced at all. SBF was able to exploit several loopholes as he directed the money to influence the elections but did not disclose where the money came from.[104]

Apart from SBF, Ryan Salame (Salame), co-CEO of FTX Digital Markets, was also a significant donor. Salame's largest contributions included US$15 million to his own super PAC supporting Republican candidates, US$2.5 million to a PAC aimed at electing Republicans to the US Senate, and US$2.5 million to a PAC focused on electing Republicans to the US House. In addition, Salame made the maximum allowable political contributions to his girlfriend Michelle Bond's 2022 congressional campaign. When questioned, he refused to comment.[105]

SBF was also accused of bribing Chinese officials to unfreeze his hedge fund accounts. He allegedly directed a US$40 million cryptocurrency payment from Alameda's main trading account to a private wallet in an attempt to persuade the Chinese government to unfreeze Alameda accounts which had more than US$1 billion of cryptocurrency. These accounts had been frozen due to an investigation into an unnamed Alameda counterparty. SBF's efforts to bribe Chinese officials were unsuccessful.[106]

The greatest showman

Prior to the collapse, SBF relied on strong marketing gimmicks and press publicity to build a reputable image for himself and FTX.

For a start, his graduation from MIT and his parents' roles as law professors at Stanford University significantly bolstered his credibility. Near the end of his reign, the public hailed SBF as "the white knight of crypto"[107] or even the potential "next Warren Buffett"[108]. Both nicknames were mentioned by Fortune magazine, an American magazine renowned for profiling successful business leaders.

SBF also was featured on Forbes' "30 under 30", an annual list of individuals with impactful careers or accomplishments before the age of 30.[109] Nominees for this list are not handpicked by Forbes' committee members. Instead, anyone can submit a form to nominate themselves or others they deem worthy of consideration. The judges evaluate various factors, including the individual's impact on society, earnings, inventiveness, potential, before finalising the list for publication.[110]

In addition to promoting himself, SBF marketed his business. In March 2021, FTX acquired naming rights to a multi-purpose arena in Miami, renaming it "FTX arena" for a grand total of US$135 million.[111] Over decades, this venue has hosted significant events like the National Basketball Association (NBA) finals and concerts by top artists like Justin Bieber and Dua Lipa. With "FTX" emblazoned across the entrance and roof, it boosted FTX's recognition.[112]

Later that year, in August, FTX secured a paid sponsorship deal with Kevin O'Leary (O'Leary), entrepreneur and judge on the television show "Shark Tank". O'Leary's role was to enhance FTX and its associated brands through marketing initiatives and he was reportedly compensated in cryptocurrency managed on the FTX platform. O'Leary expressed concerns about the regulatory challenges facing cryptocurrencies but emphasised his partnership with FTX was due to their "rigorous standards of compliance".[113]

Finally sorry

On 2 November 2023, SBF was convicted of seven charges of fraud and conspiracy after a month-long trial.[114] The charges carry a maximum of 110 years. Elizabeth Lopatto, a reporter of The Verge, said that "it's likely that he won't be treated leniently when it comes to sentencing."[115] One of the aggravating factors was that SBF did not appear sympathetic before US District Judge Lewis Kaplan (Judge Kaplan) while testifying. He reportedly gave "evasive answers" and failed to give the impression of being repentant.[116]

On 28 March 2024, SBF was sentenced to 25 years in prison for stealing US$8 billion from customers of the now-bankrupt FTX cryptocurrency exchange he founded. Judge Kaplan said that SBF showed no remorse. He further said that: "He knew it was criminal. He regrets that he made a very bad bet about the likelihood of getting caught. But he is not going to admit a thing, as is his right."[117]

Speaking to the judge, SBF acknowledged, "Customers have been suffering ... I didn't at all mean to minimize that. I also think that's something that was missing from what I've said over the course of this process, and I'm sorry for that."[118] Referring to his FTX colleagues, he added, "They put a lot of themselves into it, and I threw that all away. It haunts me every day."[119]

Meet the parents

Standing by SBF's side throughout the saga were his parents, who faced scrutiny due to their connections to FTX and active roles in supporting and promoting the company. Joseph Bankman (Bankman), a lawyer and longtime tax professor at Stanford Law School, was described on Stanford's website as a "leading scholar in the field of tax law."[120] During FTX's operating years, Bankman received payments from the company for providing legal services, although he was not involved in its management. He also assisted FTX in recruiting its first lawyers, joined executives in meetings on Capitol Hill, and advised SBF before his testimony to the House Financial Services Committee.[121]

At FTX's peak, the company hosted a charity event at the Miami Heat's arena, where high school students pitched business ideas in a "Shark Tank-like" competition for over US$1 million in prizes. Bankman organised the event and went on stage wearing a baseball cap with FTX's logo to hand out two US$500,000 cheques to the winners.[122] Over the years, Bankman had been SBF's cheerleader, promoting the idea that SBF would save the world by donating to charity and providing low-income individuals access to the financial system through cryptocurrency philanthropy.[123] He also introduced influential investors to FTX, including Orlando Bravo, founder of Thoma Bravo, who invested US$130 million in the exchange.[124]

Barbara Fried (Fried), SBF's mother, was also a lawyer and professor of law at Stanford University. Unlike her husband, she did not work for FTX or receive payments for services. Fried co-founded the political fundraising organisation Mind the Gap, which supported Democratic Party candidates.[125] It was revealed that SBF made political contributions to this organisation.[126] Meanwhile, Bankman and Fried had also benefitted from their association with FTX, which included staying in a US$16.4 million house in the Bahamas intended for company use and receiving a US$10 million cash gift.[127]

The couple had dedicated all their resources to defending SBF's innocence against criminal allegations and reportedly told friends that SBF's legal bills might wipe them out financially.[128] Additionally, their professional lives were significantly impacted. Fried resigned as Chairwoman of Mind the Gap, and Bankman postponed a class at Stanford University and enlisted a white-collar criminal defence lawyer.

However, no evidence has emerged linking Bankman and Fried to the potentially criminal practices that led to FTX's collapse and they have not been charged with any wrongdoing. Their situation remains a topic of discussion and concern among friends and colleagues, who viewed their downfall as a tragic consequence of their son's actions and the broader collapse of FTX.[129]

Investors jump in

In merely two years, FTX raised US$1.9 billion in capital from 80 investors.[130] Among them, the most notable investor was Binance, which announced its strategic investment in FTX in 2019, with the aim to foster cryptocurrency market development.[131] However this partnership dissolved in 2021.[132] In a tweet post-FTX's collapse, Zhao revealed that Binance grew "increasingly uncomfortable"[133] with SBF and FTX, justifying the decision to pull out its investment eventually.[134]

At the time of its collapse, FTX's major investors included Paradigm, Temasek Holdings, Sequoia Capital, SoftBank Vision Fund, the Ontario Teachers' Pension Plan (OTPP), and Tiger Global, collectively contributing close to a billion US dollars of invested capital.[135] All six entities have since written off their investments. Sequoia Capital, among others, expressed shock and profound regret at its decision to invest in FTX.[136]

FTX was far from perfect from an outsider's viewpoint. On one hand, doubts lingered about the legitimacy of its top brass. Chief Regulatory Officer Dan Friedberg (Friedberg) had previously been embroiled in the Ultimate Bet poker scandal and was caught on tape advising its executives to conceal their tracks to minimise repercussions.[137] On the other hand, FTX's attitude towards its investors left much to be desired. Several investors reported SBF's pitch with potential investors as allowing little room for negotiation, with his insistence on minimal oversight and investors merely "support him and observe".[138] While investors were impressed by his ideas and goals, SBF met them in a Zoom meeting while simultaneously playing League of Legends.[139] FTX executive Ramnik Arora also revealed in an interview that SBF haphazardly threw a presentation together following investors' requests for a pitch deck, which lacked proper formatting and fonts.[140]

Subsequent analysis of FTX's pitch decks uncovered a series of questionable figures and projections. A 2020 pitch deck for its Series B funding round was described as "unsubstantiated",[141] with numerous claims not backed up by assumptions or calculations.[142] Certain cost projections, particularly the payroll costs, seemed grossly underestimated. Additionally, a 2018 pitch deck by Alameda promised investors "high returns with no risk" on loans with 15% annual interest, which should have raised immediate red flags.[143]

FOMO?

At the time of FTX's growth, a trend was emerging in cryptocurrency industry investments.[144] Some investors viewed investment in FTX as a means to join the cryptocurrency trend without directly purchasing volatile tokens. Others considered FTX a safer investment compared to rival Binance, as FTX had made efforts to create a regulatory framework in Washington, while Binance faced criticism for its lack of transparency and for avoiding financial regulations worldwide.[145] Despite warning signs, investors approached FTX with a venture capitalist mindset, embracing the possibility of failure.[146]

Investors are facing hefty consequences, not just financially, for their decisions. Eighteen leading venture capital firms including Temasek Holdings, Sequoia Capital, and SoftBank Vision Fund had been hit with lawsuits from customers, accusing them of "aiding and abetting fiduciary breach"[147] through their financial support of FTX.[148] Although accused of conspiring with FTX, these firms maintained that due diligence was conducted throughout the investment process.[149] Temasek claimed it conducted thorough due diligence for approximately eight months before deciding to invest in FTX. The firm stated that its investment process involved reviewing FTX's audited financial statement, interviewing people familiar with the company, and evaluating its business strategy and compliance measures.[150]

Questions were also raised in Singapore's Parliament on the impact of FTX's collapse on the country. In response, Singapore's Minister of Finance, Lawrence Wong (Wong), said that cryptocurrency platforms can collapse due to fraud, unsustainable business models or excessive risk-taking.[151] "As long-term investors, our investment entities have to operate in this space. They do their best due diligence based on the information available,"[152] he said. Wong also admitted that the collapse of FTX caused not only financial loss to Temasek but also reputational damage.[153]

Meanwhile, investigations by the US SEC are underway to determine if these firms had implemented appropriate due diligence policies and procedures when deciding to invest in FTX.[154] US authorities had also requested detailed communication records between these investor firms and FTX.[155] However, there have been no further updates since.

The celebrity connection

Celebrities such as Tom Brady (Brady) and Gisele Bündchen (Bündchen) were also entangled in multiple lawsuits revolving around FTX. Having made appearances in commercials advertising FTX, they faced accusations of endorsing a deceptive platform which targeted vulnerable and naive investors.[156] Brady and Bündchen were also investors of FTX, owning over US$80 million in shares at its peak. At the time, their financial team also viewed FTX's financials as legitimate and trustworthy.[157]

Additionally, prior to FTX's collapse, Taylor Swift (Swift) allegedly signed a US$100 million sponsorship deal with the exchange after months of negotiations. The agreement was intended for Swift to endorse FTX through various promotional activities, but Swift refused to endorse the exchange directly, narrowing the deal to a tour sponsorship. During discussions, Swift questioned FTX about whether their assets were unregistered securities.[158]

Despite public claims highlighting Swift's caution and due diligence, Swift ultimately agreed to the deal, which was sent to FTX founder SBF but left unanswered. FTX executives later decided not to proceed with the agreement. This information contrasts with public statements that emphasised Swift's scrutiny of FTX's legal status. Nonetheless, Swift is not involved in the ongoing lawsuit seeking damages from FTX's celebrity promoters.[159]

Graveyard of governance

At the time of FTX's downfall, the company had no board of directors. Management and governance were predominantly controlled by SBF, Singh, and Wang, with SBF having the final say in all significant decisions.[160] CEO Ray further noted that many companies within the FTX Group, especially those in Antigua and the Bahamas, lacked appropriate corporate governance and many had never held a board meeting.[161]

Furthermore, Chamath Palihapitiya (Palihapitiya), CEO and founder of venture capital firm Social Capital, shed further light on FTX during a podcast. According to Palihapitiya, his firm provided several recommendations to improve FTX's corporate governance from the perspective of a potential investor, following a Zoom pitch by SBF that "did not make much sense".[162] These recommendations included forming a board and creating dual-class stock. However, Palihapitiya was rudely dismissed with expletives in a subsequent call with an FTX representative. He later described SBF and crew as "unbelievably arrogant and smug".[163]

FTX operated through an exclusive inner circle of young, relatively inexperienced individuals who lived together in lavish Bahamian property, purchased using hundreds of millions in FTX funds.[164,165] As detailed in an article by CoinDesk, this inner circle consisted of 10 individuals including SBF, Ellison, Singh, Wang, Constance Wang, Salame and others.[166] Anonymous sources close to FTX's operations described the inner circle as a "gang of kids" who would "do anything for each other".[167] A Bahamian local further described their residence as a "frat house".[168] It was also leaked that members of this group communicated via a chat group named "Wirefraud", a claim which SBF subsequently denied.[169] Further investigation revealed a lifestyle fuelled by drug use, with both SBF and Ellison making controversial posts on Twitter about their openness to drug consumption.[170] An attendee of a crypto conference by FTX further corroborated this, stating that "they were staying up all night, snorting Adderall".[171]

Closer inspection of FTX's top executives casts doubt on their true expertise and reliability. It was revealed that several of them did not appear to possess sufficient experience to hold executive positions in one of the world's biggest cryptocurrency exchange companies. In a viral podcast with El Momento, a YouTube channel focused on cryptocurrencies, Ellison revealed that she had mainly used "elementary school math" in her duties and could easily fit into her position even without her degree in mathematics.[172] She also revealed FTX's tendency not to implement stop losses,[173] indicating a possible excessive risk appetite within the inner circle, which ultimately proved detrimental given the severe losses incurred by Alameda through trading.[174] Constance also came under scrutiny for her lack of managerial experience, having graduated only three years before taking on an executive role at FTX. During that time, most of her experience was from an analyst position at Credit Suisse.[175]

Conflict of interest

The professional relationships within this circle of friends raise significant concerns about conflicts of interest. Every member of this group allegedly had personal connections to SBF before their appointments at FTX, either through his previous employer, Jane Street, or through his alma mater, MIT.[176] Ellison had worked with SBF at Jane Street, Singh was the best friend of his brother, and Wang had connected with him through a high-school math camp and later became his college roommate.[177] Furthermore, all 10 members were reported to have been in romantic relationships with each other, with only that of Ellison and SBF being publicly disclosed.[178]

This conflict of interest was further exemplified by the rampant self-dealing between FTX and Alameda, both led by SBF, Ellison, and others within the inner circle. Investigations revealed that Alameda's largest single asset was FTT tokens amounting to US$3.66 billion in unlocked FTT and US$2.16 billion in FTT-related assets, out of a reported total assets of US$14.6 billion. Essentially, Alameda was built on FTX's cryptocurrency as its main asset, blurring the lines between what appeared to be two separate legal entities.[179]

Illusion of risk management

In the case of FTX, there were no internal control mechanisms in place to monitor its leverage or ties to Alameda.[180] Despite this, SBF had previously emphasised the significance of risk management to FTX. According to a recent SEC filing, the FTX "guiding whitepaper" marketed the exchange as being built on "industry-leading risk management technologies"[181] and that its "liquidation engine" was a secure method for risk management.[182] This engine was designed to reduce risk in customers' accounts by automatically initiating specific procedures, such as selling collateral when an account accrued excessive debt. However, in reality, FTX primarily focused on providing "limitless credit" to Alameda and its business operations, resulting in essentially non-existent internal risk controls governing the usage of "uncollaterised" customer funds.[183]

The SEC's filing further stated that FTX had grossly insufficient risk management procedures that allowed all types of assets and liabilities to be treated as interchangeable. This lack of distinction between customer assets in custody provided FTX with the opportunity to invest these funds without their consent or awareness, exposing them to major risks.[184] Ray described this lack of management and financial opacity as one that is "unprecedented".[185]

Who audits FTX?

The US crypto market has largely remained unregulated, with most privately held crypto exchanges, such as FTX, not obligated to produce audited financial statements or file reports with the SEC. Additionally, a regulatory framework for audits is lacking for many crypto companies.[186]

Despite the absence of regulation, cryptocurrency firms strive to have their financial statements audited by reputable accounting firms to build reputability and trust with the public. However, given the inherently risky nature of the cryptocurrency business, not all accounting firms, particularly the Big Four firms, are willing to undertake audits for cryptocurrency firms. Consequently, this situation presents opportunities for smaller and less reputable firms to assume this high-risk responsibility.[187]

Upon its establishment in 2019, FTX engaged Armanino LLP (Armanino), one of the top 25 accounting and consulting firms in the US, to audit West Realm, which oversaw the US operations.[188] Armanino gave a clean bill of health to West Realm's financial statements in both 2020 and 2021.[189] FTX also enlisted the services of another auditing firm, Prager Metis LLP (Prager Metis), to audit the rest of its global operations. A positive assessment was also received.[190] It remains unclear why FTX commissioned two separate firms to audit different segments of its operations instead of auditing as a whole.[191]

Another issue was that both firms that audited FTX were relatively small compared to the Big Four firms. This was despite FTX being a multi-billion-dollar company with over 130 companies under its group and complexity of its operations.[192] Due to the small size of these auditing firms, the Public Company Accounting Oversight Board (PCAOB) inspects them only once every three years. Furthermore, both accounting firms have poor track records with the PCAOB.[193] In 2019, the PCAOB published its private inspection report conducted in 2018, revealing deficiencies in Armanino's overall quality-control processes, as the firm failed to address the criticisms to PCAOB's satisfaction within 12 months. Similarly, in 2022, comments were published regarding an investigation conducted on Prager Metis back in 2020.[194]

Missing ethics

Following FTX's bankruptcy, there was considerable scrutiny surrounding its ethical conduct. This scrutiny brought attention to FTX's Terms of Service, which included a clause that stated that none of the "Digital Assets in your Account are the property of, or shall be loaned to, FTX Trading,"[195] and that the platform "does not represent or treat Digital Asset in User's Accounts as belonging to FTX Trading".[196] This essentially means that FTX was authorised solely to hold funds on behalf of its customers, with no permission to utilise them for finance investments.[197]

However, it became evident that this was not strictly adhered to. Approximately US$200 million out of the billions in customer deposits that disappeared from FTX were diverted to finance investments in two businesses. Through its FTX Ventures division, the cryptocurrency firm injected US$100 million in Dave, a Fintech business that had gone public through a special purpose acquisition company. Another US$100 million was allocated to a funding round for Web3 firm Mysten Labs.[198]

FTX Ventures purportedly engaged in numerous deals. Yet, according to documents disclosed by the Financial Times, only investments of US$100 million each in Dave and Mysten Labs were publicly disclosed.[199] While there have been no allegations of wrongdoings concerning Mysten Labs or Dave, these transactions marked the first instances where FTX and SBF used client funds for venture capital investments.[200]

Regulatory landscape

The collapse of FTX has highlighted the global regulatory challenges within the cryptocurrency sphere. Due to the decentralised nature of cryptocurrencies, categorising them as either securities or commodities presents a considerable challenge. Despite efforts by the SEC to advocate for such classification, achieving consensus remains elusive.[201] Consequently, regulatory bodies such as the SEC struggle to impose stringent regulations on digital currency trading, unlike traditional asset classes like equities and bonds. This lack of regulatory oversight exposes users to heightened risks and compromises market integrity, particularly during times of market turbulence.[202]

Furthermore, while financial regulation in the US is built on the disclosure of risks, the cryptocurrency industry largely lacks comprehensive or standardised disclosure practices. The operational lines of crypto enterprises are frequently obscured and plagued with disputes due to their frequent offering of a myriad of products and services across different platforms.[203]

Moreover, regulatory approaches toward cryptocurrency vary widely across the globe. While some countries like China have outright banned cryptocurrencies since 2021,[204] others, like El Salvador, have embraced Bitcoin as legal tender, allowing citizens to transact using it as the national currency.[205] Many countries find themselves somewhere in between these extremes. For instance, Japan permits cryptocurrency trading under the regulation of the Japanese Financial Services Agency (FSA).[206] Meanwhile, countries like the US are still in the midst of seeing the SEC clamp down on cryptocurrency, a process that has been ongoing for years.[207]

A Caribbean cryptohaven

The Bahamas appeared to embrace FTX with open arms, offering an ideal destination for SBF to relocate his business from Hong Kong amidst China's cryptocurrency crackdown and strict COVID-19 regulations at the time.[208] As one of the region's numerous tax havens, alongside Bermuda and the Cayman Islands, the Caribbean nation imposes no personal or corporate taxes on its residents, citizens, or companies, rendering it highly attractive for business establishment and operation.[209,210] Seeking to diversify its revenue sources away from tourism, the Bahamas focused on bolstering its financial sector, with cryptocurrency playing a significant role.[211]

The Bahamas expressed its desire to open up to the crypto world, introducing "comprehensive regulatory regimes for cryptocurrency,"[212] as described by SBF, allowing exchanges to obtain licenses for both crypto derivatives and the spot market.[213] In 2019, the SCB released the Digital Assets and Registered Exchanges (DARE) Bill,[214] outlining regulations concerning cryptocurrency and showcasing the nation's progressive stance.[215]

Following its collapse, FTX's crypto wallets were surrendered to the government's control for safekeeping as per the orders of the SCB.[216] Its assets worth US$3.5 billion were also seized, with the intent of redistribution to its customers and creditors.[217] The suspension of FTX Digital Markets' license was also ordered.[218] Subsequently, liquidators were engaged by the Bahamian authorities to facilitate the winding down of FTX and its operations.[219]

Despite the seemingly swift action taken by the Bahamian authorities, questions arose about the legitimacy of their methods when allegations surfaced that they had seized FTX's digital assets through unauthorised means, potentially via a system hack.[220] This action violated the automatic stay injunction, which freezes the debtor's assets, temporarily prohibiting collection activity from creditors after the filing of bankruptcy.[221] Such allegations cast further doubt on the Bahamas, as this potential violation was reportedly carried out by Bahamian government bodies themselves.

The revelation of FTX's multiple misdeeds fuelled speculation that its relocation to the Bahamas was primarily an act of not wanting to "submit to regulatory scrutiny".[222] However, Ryan Pinder (Pinder), Bahamas' attorney general, disputed this notion, highlighting the adequacy and effectiveness of the nation's crypto regulations. Pinder buttressed his argument by stating the lack of global standards for such crypto regulations. Additionally, he reinforced the efficiency and reliability of the regulatory regime, asserting that it had acted in accordance with the law, reassuring investors and tourists of the nation's safety.[223]

The Bahamian government also faced criticism for failing to detect Alameda's use of FTX customer funds to conceal losses. Despite Alameda not falling under Bahamian oversight, FTX was still required, under the DARE Act, to possess "effective arrangements in place to protect client assets and money".[224] Limited jurisdiction also prevented the surveillance of many FTX-related units, in particular, to monitor if they possessed adequate safeguards to prevent any conflict of interest.[225] Additionally, only Bahamian citizens were permitted, by both the Bahamian government and SBF, to recover funds from FTX following its collapse, leaving customers in other nations waiting for a chance to recover their money.[226,227] Following the reopening of FTX withdrawals, Blockchain analytics platform Nansen tracked outflows of up to US$7.2 million.[228] A tweet by FTX attributed this phenomenon to its "Bahamian HQ's regulation and regulators", stating that it had acted in compliance with regulators through this process.[229]

FTX's downfall dealt a significant blow to the Bahamas, causing a loss in revenue and leaving a void in its financial sector. Despite the uncertainties surrounding it, rating agency Standard and Poor's (S&P) forecasted stability in the nation's economic outlook and has predicted that the collapse of FTX would likely not have a material impact on the Caribbean nation's economy.[230]

Will the FTX crash kill crypto?

The impact of FTX's collapse extends far beyond the company itself, reverberating throughout the entire cryptocurrency industry. Shortly after FTX's bankruptcy, other cryptocurrency firms with financial exposure to FTX suffered as their funds were frozen. Galois Capital, a cryptocurrency hedge fund, ceased its operations after substantial assets "got stuck in the bankrupt exchange FTX".[231] Other industry victims of the collapse include Binance and Genesis Trading.[232]

Beyond the immediate financial repercussions, the most profound impact of FTX's collapse is the long-term erosion of confidence in cryptocurrencies.[233,234] While the negative impacts of the FTX saga could potentially signal the end for the entire industry, there is also the potential for a different outcome. With the involvement of stakeholders, especially regulators, FTX's collapse could radically transform the industry and reshape the crypto space in the years to come.[235]

In June 2023, the European Union implemented the Markets in Crypto-Assets Regulation (MiCA). This regulation includes numerous Level 2 and Level 3 measures that ought to be developed before the new regime is fully implemented, within a 12-to-18-month deadline depending on the mandate.[236] Additionally, MiCA imposes liability on exchanges if they mishandle investors' funds and assets, thereby reducing risks for crypto investors. Given the decentralised nature of cryptocurrency, centralising the industry will require "proper oversight and proper balance of power".[237] Regulations that offer adequate protection will help rebuild customer confidence in the crypto industry in the long run.[238]

Final chapter

Fast forward to February 2024, FTX announced that it has abandoned plans to restart its crypto exchange, opting for liquidation to fully repay customers. This decision came after months of negotiations with potential bidders and investors, but none were willing to invest enough money to rebuild FTX. FTX has since recovered over

US$7 billion in assets to repay customers and has reached agreements with government regulators to prioritise customer repayment over other claims.[239]

> "We are pleased to be in a position to propose a chapter 11 plan that contemplates the return of 100% of bankruptcy claim amounts plus interest for non-governmental creditors,"
>
> *– John J. Ray III, CEO of FTX*[240]

On 8 May 2024, FTX announced that customers will recover all their funds lost after the company's implosion two years ago. Creditors are set to receive US$11.2 billion following a bankruptcy plan unveiled by CEO Ray, which aims to raise US$14.5 billion to US$16.3 billion by selling off assets. However, repayment will be based on Bitcoin's value at the time of the collapse, with some users receiving interest. Creditors with claims of US$50,000 or less will get about 118% of their claim, covering 98% of customers. FTX recovered funds through the monetisation of assets from Alameda and FTX Ventures, as well as litigation claims.[241]

Meanwhile, top executive Salame was sentenced to seven and a half years in jail on 28 May 2024, making him the first of SBF's inner circle to serve time behind bars. Three other senior FTX executives, Wang, Singh, and Ellison, also pleaded guilty to financial crimes and have agreed to cooperate with the government. They are all awaiting sentencing.[242]

In light of these developments, it remains to be seen if trust in cryptocurrency can be fully restored, particularly with the looming prospect of stricter regulations from the US government.

Discussion questions

1. What were the key red flags in FTX's governance, management, business model and operations? What were the major factors that contributed to its collapse?
2. *John J. Ray III*, the new CEO of FTX, said: "The FTX group's collapse appears to stem from absolute concentration of control in the hands of a small group of grossly inexperienced, non-sophisticated individuals." Why do you think this situation was allowed to develop given the size and scale of FTX's operations?
3. Do you think if FTX had adopted a governance model similar to publicly-listed companies, including the appointment of independent directors, the collapse could have been prevented and FTX could have been successful? Explain.
4. What were some of the key ethical issues in the FTX's case? Do you think crypto exchanges and other crypto firms can be run ethically or are these firms inherently unethical given the number of issues that have emerged with these firms? Explain.
5. What are the essential elements of effective risk management? To which extent did poor risk management contribute to the collapse of FTX? Explain.
6. Critically evaluate FTX's auditing practices. To what extent, if any, did they contribute to FTX's collapse? Explain.
7. Despite clear warning signs, many investors still chose to invest in FTX. What factors may have influenced their decision? Do you think the investors and celebrities who endorsed FTX are also responsible for the FTX debacle and should they be held accountable? Explain.
8. What were some of the key regulatory issues in the FTX's case that allowed FTX to flourish before its eventual collapse? Do you think regulators bear some responsibility for the rise and fall of FTX? Explain. How to you think crypto exchanges and other crypto firms should be regulated?
9. The collapse of FTX was precipitated by a media article exposing its vulnerabilities. Discuss the role of the news media in promoting good corporate governance and transparency in companies. To what extent does the media play a role in your country in promoting good corporate governance and transparency?

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SILICON VALLEY BANK ON THE RUN

Case overview

Silicon Valley Bank (SVB), widely recognised as the preferred financial institution for technology enterprises, particularly start-ups, was the 16th largest bank in the United States (US) at the end of 2022. However, SVB encountered a significant downturn precipitated by the US Federal Reserve's (Fed) decision to raise interest rates in 2022. Substantial unrealised losses on SVB's bond portfolio began to surface, prompting the bank to realise these losses to generate liquidity. Customers became alarmed and started to withdraw money in waves. In just 48 hours, SVB collapsed on 10 March 2023.

The objective of this case study is to facilitate a discussion of issues such as corporate governance of financial institutions; board composition; risk management; role of regulators; and regulatory challenges.

The birth of SVB

Silicon Valley Bank (SVB), headquartered in Santa Clara, California, was founded by Bill Biggerstaff and Robert Medearis in 1983.[1] The bank was established to support technology entrepreneurship and offer innovative commercial banking services tailored to the unique needs of this sector.[2] It pioneered a new approach to start-up lending by focusing on close relationships with entrepreneurs and providing loans with an understanding that startups might not generate revenue in their early stages.[3] In 1988, SVB went public and listed on the National Association of Securities Dealers Automated Quotations (NASDAQ) stock exchange, raising a total of US$6 million.[4] During the 1990s, SVB began expanding nationwide and eventually developed strong international relationships, enabling it to offer its services globally.[5]

Many institutional investors invested in SVB. As of the end of December 2022, major investors included Vanguard with an 11.21% stake, State Street Global Advisors with 5.21%, and BlackRock with 5.18%. Other institutional investors with relatively large stakes included Alecta Pensions, J.P. Morgan, and Artisan Partners.[6]

This case study was originally prepared by Binson Koh, Chew Keng Horng, Lam Si Kai, Lim Wee Pin, Loh Yee Kin, and Tan Jing Xuan Tricia. It has been edited by Or Yun Qian and Koh Yan Qi, under the supervision of Professor Mak Yuen Teen, with additional content added. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees.

The high of SVB's rollercoaster ride

Fast forward to 2022, SVB was the 16th largest bank in the United States (US) and the primary subsidiary of SVB Financial Group.[7] SVB served a customer base of 40,000, predominantly technology companies, and offered services to approximately half of all start-ups in the US.[8] Some of the largest technology companies that had ties with SVB include Circle, Roku, and Block-Fi with approximately US$3.3 billion, US$487 million, and US$227 million in deposits respectively in 2023.[9] Other key industries that SVB focused on were life sciences and healthcare.[10]

SVB provided a comprehensive suite of credit solutions to its commercial clients, comprising of "traditional term loans, growth capital term loans, equipment loans, asset-based loans, revolving lines of credit, warehouse facilities, recurring revenue facilities, mezzanine lending, acquisition finance facilities, corporate working capital facilities, standby and commercial letters of credit, project finance loans and credit card programs".[11]

Between 2017 and 2022, SVB was on an asset growth trajectory. In the five years preceding its eventual demise in 2023, SVB's assets grew by 316%, with the majority of this increase occurring between 2019 to 2021.[12] By the end of 2022, SVB had assets totalling US$209 billion, as reported by the Federal Deposit Insurance Corporation (FDIC).[13] Additionally, SVB experienced a consistent upward trend in net profits and profit margins over the past 12 years.[14]

SVB's share price exhibited a steady upwards trajectory since the early 2000s. In the five years leading up to its collapse, its share price peaked at US$755.03 per share during the COVID-19 pandemic.[15]

SVB's turbulence

During the technology boom of the late 1990s, starry-eyed investors poured money into young technology companies, inflating the untested industry into an overvalued bubble. This bubble burst in the early 2000s, driven by factors such as rising interest rates and the onset of a recession in 2000, which triggered widespread capitulation.[16,17] When the NASDAQ plunged 78% from its peak in March 2000 to its trough in October 2002, SVB's shares similarly dropped by 77%.[18] Despite this, SVB was among the 48% of dotcom firms that survived the bust.[19]

The great salvation

In the late 2000s, another bubble arose as banks offered subprime mortgages to borrowers with poor credit histories.[20] These loans were repackaged as mortgage-backed securities (MBS) and sold to investors. When interest rates increased, borrowers defaulted on their mortgages, causing major financial institutions to face insolvency due to their exposure to these risky loans.[21] The bursting of this housing bubble triggered the broader financial crisis which warranted various bailout measures by governments and central banks.[22] SVB was no exception. It received a US$235 million bailout from the Federal Reserve (Fed) via the Troubled Asset Relief Program.[23]

Tech boom to tech gloom

By the mid-2010s, SVB had investments in over half of the technology start-ups in the US.[24] During the initial stages of the COVID-19 pandemic, the Fed maintained interest rates close to zero to stimulate economic growth amidst the economic contraction.[25] Countrywide lockdowns accelerated the adoption of technology products, significantly benefiting the technology sector due to low interest rates. This environment fuelled sky-high valuations and made 2021 a record year for initial public offerings (IPOs) in the technology sector.[26] From 2019 to the end of 2020, SVB's assets and other investments grew by 63%, and by 83% in the following year, 2021.[27]

However, in November 2021, the technology boom collapsed, causing many of SVB's technology customers to liquidate their deposits in 2022 to support their operations.[28] Subsequently, the Fed, in their efforts to curb persistently high inflation, aggressively raised interest rates which further exacerbated the drying up of venture capital for the technology sector.[29] From March 2022 to February 2023, the US Federal Funds Rate rose from 0.25% to 4.75%.[30] The high borrowing costs led to a lack of IPOs and private fundraising. Consequently, many of SVB's customers had to withdraw their deposits to fund their working capital.[31]

On 27 February 2023, less than two weeks before SVB's collapse, the bank's former Chief Executive Officer (CEO), Greg Becker, sold over US$3.5 million worth of his shares in the company.[32] On the same day, SVB's former Chief Financial Officer (CFO), Daniel Beck (Beck), sold shares worth US$575,180.[33]

The bank run

On 8 March 2023, SVB announced the sale of US$21 billion securities to fund customer withdrawals, incurring a US$1.8 billion loss.[34] Prominent venture capital firms, such as Coatue Management and Union Square Ventures, began advising portfolio companies to withdraw their money from the bank as a precaution.[35] This raised the volume of withdrawals at a time when the bank was already struggling to meet its liquidity needs. Concurrently, Moody's downgraded SVB's credit rating due to negative outlook for the bank.[36]

The next day, SVB announced that it would raise an additional US$1.75 billion in capital through a secondary shares sale.[37] This included US$1.25 billion in common shares and US$500 million in convertible preferred shares.[38] The capital was needed to cover the US$1.8 billion loss from the securities sales the day before.[39] However, this announcement alarmed depositors and investors who interpreted it as a sign of the bank's deteriorating financial position.[40] To exacerbate matters, social media platforms such as Twitter and WhatsApp were used by depositors to spread the news, leading to mass panic and waves of withdrawals as SVB's customers attempted to salvage their deposits.[41] This resulted in SVB's stock price plummeting by over 60%, from US$267.83 to US$106.04.[42]

On 10 March 2023, following a staggering withdrawal of over US$42 billion and ending with a cash balance of negative US$958 million, SVB abandoned its equity raise initiative and instead sought to find a buyer.[43] Later that day, the California Department of Financial Protection and Innovation seized the bank's assets and shut the bank down.[44] SVB was placed under the receivership of the FDIC.[45] With that, SVB became the largest US lender to collapse in over a decade, occurring less than 48 hours after the disclosure of its capital-raising plans.[46] Becker was removed from the board of directors of the Federal Reserve Bank of San Francisco on the same day and subsequently resigned from SVB on 19 April 2023.[47] Meanwhile, Beck resigned from SVB a day earlier on 18 April 2023.[48]

On 11 March 2023, SVB's United Kingdom (UK) arm shut down.[49] Two days later, SVB's branches in Canada and Germany were frozen.[50]

FDIC to the rescue?

> "The American people and American businesses can have confidence that their bank deposits will be there when they need them,"
>
> — *US President Joe Biden*[51]

On 12 March 2023, facing a lack of immediate buyers for SVB, the FDIC announced that it would extend its insurance coverage to all of SVB's deposits.[52] Traditionally, the FDIC has a US$250,000 insurance upper limit for deposits per depositor, per insured bank.[53] However, numerous technology companies had deposited more than US$250,000 with SVB.[54] It was found that 93.9% of SVB's deposits were uninsured, the second highest among all banks in the US.[55]

The Fed, FDIC and the Treasury Department released a joint statement to announce that a "systematic risk exception" was to be invoked for SVB (and fellow New York-based lender Signature Bank that collapsed over the same weekend), ensuring that all depositors would be compensated.[56] Shareholders and unsecured debt holders were not covered under this exception and any losses to the Federal Deposit Insurance Fund (DIF) in fulfilling payouts for the uninsured amounts would eventually be recovered via a special assessment.[57] To safeguard insured depositors, the FDIC formed the Deposit Insurance National Bank of Santa Clara.[58] Insured depositors regained access to their funds on 13 March 2023.[59] Uninsured depositors received an advance dividend from the FDIC, which is a payment equal to a portion of their uninsured funds, with the remaining funds distributed through dividends after the sale of SVB's assets.[60]

This bailout was initiated as the US government sought to prevent the negative spillover effects of SVB's collapse on the technology sector.[61] Furthermore, there was a need for regulators to curb the fear of contagion as depositors with uninsured amounts in other banks may begin to withdraw their money as a precaution, potentially leading to another bank run.[62] Complicating matters, implementing monetary policies such as lowering interest rates to stabilise banking volatility was not possible due to the current inflationary environment.[63] As such, the US government attempted to reassure depositors through this bailout.[64]

On 26 March 2023, the FDIC announced that First Citizens Bank will purchase SVB and take control over most of its deposits and loans.[65] Assets worth US$72 billion would be purchased at a discounted rate of US$16.5 billion.[66] The remaining US$90 billion of SVB's assets and securities would be controlled by FDIC in its receivership.[67]

As a form of crisis management on 31 March 2023, the 2009 Banking Act's Special Resolution Regime (SRR) was utilised to orchestrate the sale of SVB's UK arm to HSBC.[68]

Those left behind

Unlike depositors, SVB shareholders and investors were not insured for their investments by the FDIC thus had to bear their own losses.[69] Many technology companies also faced temporary financial difficulties in settling their immediate expenses, such as payroll, following the collapse.[70] This was especially true since most of these technology companies kept their working capital in SVB primary accounts rather than money market accounts.[71] These companies, including Etsy, Roblox, Rocket Labs, and Roku, would have to wait for the FDIC to sell off SVB's assets to gain access to their uninsured deposit amounts.[72] Roku, for example, had US$500 million with SVB, while Roblox had US$150 million.[73]

Though seemingly unrelated, the contagion of SVB's collapse also spread to the cryptocurrency market. SVB was not only the largest lender of unicorns and start-ups but also the custodian for the reserves of various cryptocurrency companies, including US crypto firm Circle, which had more than eight percent of its USD Coin (USDC) reserves parked in SVB.[74] USDC lost its 1:1 dollar peg against the USD after it was revealed that Circle had US$3.3 billion of its US$40 billion USDC reserves held at SVB.[75] The USDC fell to as low as US$0.86 on 11 March 2023, following SVB's bank run.[76] The coin regained its peg only after the FDIC's announcement on 12 March 2023, allowing Circle to regain access to its SVB reserves on 13 March 2023.[77]

Beyond its impact on the technology and crypto sector, the collapse of SVB sparked a contagion effect across the banking sector as well. By the end of 2022, the FDIC estimated that unrealised securities losses totalling US$620 billion were recorded on the balance sheet of all US banks.[78] On 12 March 2023, regulators took action to close Signature Bank, marking the third bank failure within a week, following the collapse of Silvergate Bank on 8 March 2023.[79] The repercussions in the markets continued later in the week, when shares of First Republic Bank plummeted by over 60% on 13 March 2023.[80]

Unravelling the collapse

During the technology boom of 2020 to 2021, SVB invested capital obtained from the growth of its deposits and assets into fixed-income securities with long maturities, including US government bonds and MBS issued by US government agencies.[81] This was against the backdrop of a low interest rate environment, making long-term securities more attractive than short-term bonds.[82] Consequently, there was an increase in cash balance and a moderate rise in held-to-maturity (HTM) bonds.[83] Between Q12020 and Q12022, SVB increased the size of its bond portfolio from US$27 billion to US$127 billion using deposits collected from its customers.

In 2021, deposits surged by 86%, but cash balance saw a 17% decline. This was due to SVB's purchase of government bonds, causing a 492% increase in HTM bonds held.[84]

In 2022, SVB, with US$212 billion in total assets, was considered solvent. The breakdown was as follows:[85]

- US$14 billion (6.60%) in cash deposited at the Fed.
- US$26 billion (9.91%) in bonds classified as available-for-sale (AFS) and sold on the market.
- US$91 billion (42.92%) in bonds classified as HTM, with an unrealised loss of US$15 billion as of 31 December 2022.
- US$74 billion (34.91%) in customer loans.

In 2021 and 2022, SVB's investment income from HTM bonds grew at a much faster rate than its loan income.[86] The 1290% increase in interest expense paid to depositors in 2022 can be attributed to the spike in total deposits in 2021.[87]

Additionally, SVB depended heavily on deposits to finance its assets, leading to a deposit-to-total assets ratio of 83.9%, higher than its peers at 81.42%.[88] The rising interest rate environment pushed down the prices of fixed income securities held by SVB to amounts below their maturity value, leading to a drop in SVB's bond portfolio. Its income statement recorded a loss of US$285 million in 2022, with SVB exposed to unrealised losses of at least US$15.76 billion.[89]

To make matters worse, SVB had overlaid mortgage-backed securities (MBS) with its treasury investments.[90] Unlike treasury bonds, MBS durations and interest rate sensitivities fluctuate significantly over time. This variability is further exacerbated by the increase in yields. The ICE BofA MBS index, which tracks the performance of USD fixed-rate MBS, showed the largest rise in duration in the history of the MBS market between 2020 and 2022.[91] This coincided with the severe bear market for Treasuries caused by the Fed's interest rate hikes, creating a "perfect storm" that likely destabilised SVB's balance sheet.[92] In addition, the choice of investing in MBS meant there were no suitable hedging tools available, as basic interest-rate hedging instruments such as interest-rate swaps would not have provided a fully effective hedge.[93] Hence, the interest rate risk and liquidity risk embedded in SVB's balance sheet ultimately contributed to its collapse.

Bank or venture capital fund?

SVB's overreliance on the technology sector for its clients portfolio rather than diversifying across various industries left it susceptible to industry-specific headwinds.

In the months leading up to the collapse, SVB boasted at least 2,500 venture capital and private equity funds as customers.[94] These funds had significant leverage over their own customers, often requiring their portfolio companies to bank with SVB.[95] As of 31 December 2022, the book value of SVB's loan portfolio was US$74 billion, with more than 50% dedicated to venture capital and private equity firms.[96] The remainder of SVBs loan portfolios consisted of mortgages for high-net-worth individuals (14%), direct loans to technology and healthcare companies (24%), and direct loans to early and growth stage start-ups (9%).[97]

In particular, 89.38% of total deposits at SVB came from a small group of depositors in the venture capital industry.[98] This lack of diversification meant that a downturn in the technology sector could lead to simultaneous withdrawals, which was what happened when the technology boom collapsed in 2022.[99]

"Everything is fine, nothing to worry about"

On 8 March 2023, SVB's revealed its intention to sell off AFS investments at a loss of USD$1.8 billion after Silvergate Bank announced the winding down of its operations. These developments collectively jolted the financial market, fostering an atmosphere of uncertainty and mistrust.[100]

Yet, the following day, CEO Becker, who had maintained silence until then, offered a brief statement, urging stakeholders to remain calm yet leaving several critical questions from depositors and investors unanswered.[101] Rather than strengthening its financial position, it had the opposite effect as there was a lack of detail in the firm's action plan.[102] The ensuing online frenzy on social media also exacerbated doubts, compounding the unease of investors and depositors already rattled by Silvergate Bank's closure.[103]

Furthermore, SVB lacked a communication executive within its leadership team.[104] The poorly timed press release failed to consider the psychological impact on its investors and clients, further unsettling the already hypersensitive market.[105] Moreover, SVB's message lacked a fundamental narrative that could reassure key stakeholders about the bank's financial position and the strategies it intended to implement in order to bolster its balance sheet.[106]

Social media fuelled the run?

> "The effect influencer tweets had on the speed and size of the SVB bank demonstrated the speed in which social media has accelerated the speed and the reach of communication."
>
> — *Mark Williams, Master Lecturer of Finance, Boston University*[107]

SVB's bank run was instigated by substantial withdrawals from technology companies, driven primarily by depositors' panic about the bank's financial challenges and fears that they might not recover their funds,[108] especially since a large proportion of these sums were uninsured. This panic was further aggravated by the rapid dissemination of news through social media. Depositors utilised these platforms to discuss the bank's challenges and their intentions to withdraw.[109] The close network between start-ups and venture capitalist investors influenced technology companies to act in accordance to the recommendations of these investors, ultimately leading to widespread withdrawal.[110]

Decoding the board

Before the bank's collapse, SVB's board of directors consisted of 12 members.[111]

Becker, aged 56, was appointed SVB's President and CEO in 2011. He was the only non-independent director on the board. Becker joined SVB in 1993 as part of the Northern California Technology Division and held several executive and senior management roles, including Division Manager of Venture Capital, Chief Banking Officer, Chief Operating Officer, and President of the Bank. Outside SVB, he served in various directorships and positions, including executive council member at the Silicon Valley Leadership Group, Chairman of the TechNet Executive Council, and a Class A director at the Federal Reserve Bank of San Francisco. Becker holds a Bachelor's degree in Business from Indiana University.[112]

Beverly Kay Matthews (Matthews), aged 65, joined SVB as an independent director (ID) in 2019 and was subsequently appointed as the Board Chair in 2022. She also sat on the Audit Committee (AC), Governance & Corporate Responsibility Committee (GCRC), and Risk Committee (RC). Matthews possesses extensive finance, accounting, and auditing experience as an independent auditor throughout her career. She also has broad experience within the technology and venture capital/private equity sectors. She previously served as a Vice Chair of Ernst & Young LLP and working as a Senior Advisory Partner for key clients within the technology, healthcare, and biotech fields. Matthews holds a Bachelor's degree in Accounting from Texas Tech University.[113]

Eric Benhamou (Benhamou), aged 68, joined SVB as an ID in 2005. He was the Chairman of GCRC, and a member of the RC and Finance Committee (FC). Benhamou possesses strong strategic, leadership, and operational experience in global capital markets and has expertise in venture capital. He is the founder and General Partner of Benhamou Global Ventures, LLC and previously served as the CEO of 3Com Corporation and Palm, Inc. Benhamou holds a Master's degree in Science from the School of Engineering at Stanford University.[114]

Elizabeth "Busy" Burr (Burr), aged 62, was appointed as an ID in 2021. She sat on the AC and Technology Committee (TC). Burr brings with her strong customer experience and extensive expertise in marketing, innovation, and digital transformation within the financial services industry. She previously held the positions of President and Chief Commercial Officer of Carrot, Inc. a B2B2C digital health company. Prior to this, Burr held various executive management roles at Humana Inc., Citi Ventures, Morgan Stanley, Credit Suisse First Boston, and Gap, Inc. She holds a Master's degree in Business Administration from Stanford University.[115]

Richard Daniels (Daniels), aged 69, was appointed as an ID in 2020. He was the Chairman of TC and served as a member on the AC, RC, and Compensation & Human Capital Committee (CHCC). With extensive experience in information technology leadership, Daniels retired from Kaiser Permanente, a nonprofit integrated managed care consortium, in 2020, where he held the positions of Executive Vice President and Chief Information Officer. Prior to this, Daniels held management positions at Capital One Financial Corporation, J.P. Morgan Chase & Co., NetServ, Inc., and DataPoint Corporation. He holds a Bachelor's degree in business management from Texas State University-San Marcos.[116]

Alison Davis (Davis), aged 62, joined SVB as an ID in 2020. She served as a member on the AC, CHCC, and TC. With broad expertise in finance and management, Davis is a Managing Partner and Co-Founder of Blockchain Coinvestors. Additionally, she has held a variety of key management positions in the finance and venture capital industries, including at Belvedere Capital Partners, Inc., Barclays Global Investors, A.T. Kearney, and McKinsey & Company. Davis holds a Master's degree in Economics from Cambridge University and another Master's degree in Business Administration from Stanford University.[117]

Joel Friedman (Friedman), aged 76, was appointed as SVB's ID in 2004. He chaired the FC and served as a member on the GCRC and RC. Friedman has extensive leadership experience in the banking and venture capital industries. He retired in 2005 from Accenture PLC, where he held the position of President of the Business Process Outsourcing organisation. He has also served as a director on various companies and organisations, including Neustar, Inc., FTV Capital, and Endeca Technologies. Friedman holds a Master's degree in Business Administration from Stanford University.[118]

Thomas King (King), aged 63, joined SVB as an ID in 2022. He was a member on the CHCC. King has over 35 years of banking experience in areas such as investment banking, markets, and corporate banking. He is the former CEO of Investment Banking at Barclays PLC and served as the Chair of the Investment Banking Executive Committee and a member of the Barclays Group Executive Committee. Additionally, he held several senior positions at Citigroup, including Global Head of Mergers and Acquisitions and Head of Investment Banking for the EMEA Region. He is currently an Operating Partner at Atlas Merchant Capital LLC, a global investment firm. King holds a Master's degree in Business Administration from the Wharton School, University of Pennsylvania.[119]

Jeffrey Maggioncala (Maggioncala), aged 55, was appointed as an ID in 2012. He served as a member on the CHCC and TC. His expertise lies in consulting, investment advisory, and financial services. He is currently the

CEO of Coursera, Inc. and serves on Coursera's board of directors. Previously, he served as the founding CEO and director of Financial Engines, Inc. Following his tenure at Financial Engines, he worked as a senior advisor to McKinsey & Company. Maggioncala holds a Master's degree in Business Administration from Stanford University.[120]

Mary Miller (Miller), aged 68, joined SVB as an ID in 2018. She chaired the AC and served as a member on the FC and RC. Miller brings in-depth experience in financial markets and the investment advisory industry. Previously, she served as the Under Secretary for Domestic Finance for the US Treasury and held roles as Assistant Secretary of the Treasury for Financial Markets. Miller holds a Master's degree in City and Regional Planning from the University of North Carolina at Chapel Hill. She is also a Chartered Financial Analyst.[121]

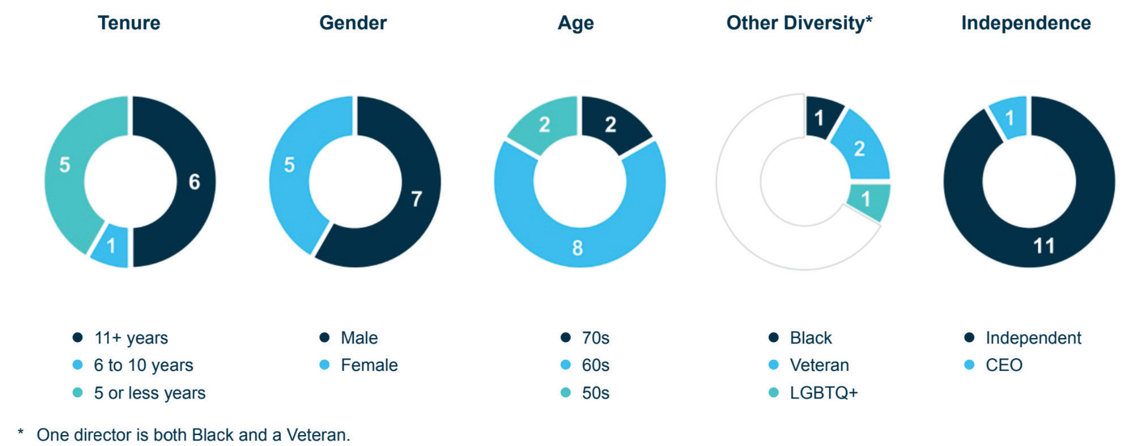
Kate Mitchell (Mitchell), aged 65, was appointed as an ID in 2010. She served as the Chairman of RC and was a member of the FC and TC. Currently, Mitchell is a Partner and Co-Founder of Scale Venture Partners. Before that, she spent 20 years in various leadership positions at Bank of America in technology, finance, and operations. She holds a Master's degree in Business Administration from Golden Gate University.[122]

The last ID is 79-year-old Garen Staglin (Staglin), who was appointed in 2011. He was the Chairman of the CHCC and a member of the GCRC and RC. Staglin has extensive experience in financial services, particularly transaction and payment processing. Staglin is the founder and proprietor of Staglin Family Vineyard. Over the past 40 years, he also held a variety of positions in the financial services and insurance industries, as well as directorships of various public and private companies. He holds a Master's degree in Business Administration, Finance and Systems Analysis from Stanford University.[123]

Board diversity

SVB's board consists primarily of IDs, with 92% of its members identifying as independent, except for Becker. In terms of diversity, 42% of the directors were women and the board had one LGBTQ+ director and two veterans. The average tenure among the directors is 7.6 years, with an average age of 65 years.[124] Figure 1 shows the profile of SVB's board of directors.

Figure 1: Profile of SVB's board of directors[125]



Source: Silicon Valley Bank. (2023, March 3). Proxy statement.

Banking on experience

> "I could only find one member on the board with formal banking experience: Thomas King, who is former CEO of Investment Banking Division at Barclays plc"
>
> – *Shivaram Rajgopal, A professor in Columbia Business School*[126]

In the process of selecting the most suitable directors to oversee SVB, the GCRC discusses recruiting strategies and actively evaluates potential director candidates, regardless of whether there is an immediate vacancy on the board to fill.[127] Occasionally, the GCRC engages reputable recruiters to identify potential candidates.[128]

While the board possessed a wealth of experience in their respective fields, a deficiency in the board's ability to effectively manage the institution was evident in the Fed's 2022 Governance and Risk Management examination.[129] This revealed a significant vulnerability in SVB's governance structure, primarily the absence of substantial large bank experience among the board members.[130] While several directors had banking experience in large global banks, a number of them lacked recent involvement in crucial leadership roles within these financial institutions.[131] For example, Daniels last worked in J.P. Morgan in 2004 with only two years of experience.[132] Burr, a former managing director of Citi Ventures pivoted from banking to the healthcare and technology industry in 2015.[133]

Following the collapse of SVB, numerous critics began to highlight the board's limited knowledge in commercial banking.[134] The lack of experience in managing the bank as it grew in size, along with other factors relating to critical oversight in risk management and governance, were seen to have contributed to the eventual downfall of the bank.[135]

Board committees

SVB had six board committees: the AC, CHCC, FC, GCRC, RC, and TC. The chairs of these six committees were IDs, appointed annually by the board.[136] The Chair of each committee was responsible for presiding over meetings and served as a vital link between committee members and the management team.[137] Regular meetings were conducted by each committee, with detailed summaries and recommendations reported to the full board.[138]

In May 2022, a review conducted by the FED highlighted fundamental weaknesses in SVB's board effectiveness, risk management, and internal audit procedures.[139] The report stated that SVB did not have an adequate risk management structure and its internal audit department did not sufficiently challenged management. In particular, the internal audit department faced deficiencies in their processes and reporting to deliver timely, independent assurance information.[140]

In 2022, following a review of the company's board and corporate governance practices, the board, in consultation with outside advisors, implemented changes in its oversight practices. These changes included establishing a new TC, consolidating and reinforcing enterprise risk oversight under the RC, increasing the focus on the GCRC's role in overseeing corporate responsibilities, and placing more emphasis on the CHCC's responsibilities in managing human capital.[141]

While efforts have been made to improve on the weaknesses highlighted by the Fed, the measures taken by SVB have been regarded as "reactive as opposed to proactive".[142] This is evident when SVB failed to meet the Enhanced Prudential Standards (EPS) set by the Fed in earlier reviews. The board responded by publishing a summary of the gaps in the bank's risk management framework, which the Fed felt had focused primarily on EPS compliance rather than actively addressing the inherent risks of the firm.[143]

Problematic compensation

SVB had implemented an executive compensation program adhering to a set of key principles and methodologies. The program was centred around pay for performance, particularly long-term performance to align shareholder's interest and drive accountability.[144] Risk management was also an important component of compensation decisions.[145]

In 2022, SVB's compensation structure consisted of both cash and equity components. Executives received cash compensation comprised of a base salary and an annual incentive compensation plan, while equity compensation involved the issuance of performance-based restricted stock units, stock options, and restricted stock units – all long-term incentives designed to align executives with shareholder's interest.[146]

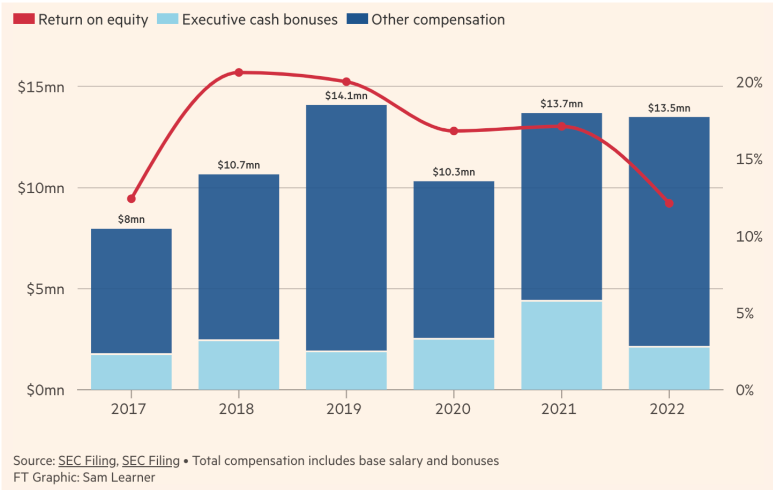
SVB employed various financial and non-financial performance measures for its compensation scheme. Among these, the bank identified return on equity (ROE) as the primary financial performance measure as it believed that it is "the most appropriate indicator of our [the bank's] short-term and long-term financial performance".[147] Hence, 90% of the CEO's total target compensation and 81% of other named executive officer (NEO)'s target compensation is "at-risk" based on company and share price performance.[148]

Profitability vs risk

In an examination conducted by the Fed, major gaps in SVB's compensation program were identified.

Firstly, SVB compensation program was heavily focused on financial performance with no linkage to risk management. This is evident in the period from 2017 to 2021 when SVB's CEO and NEOs compensation had increased due to the large multi-year bonus awards pegged to the bank's rising ROE as depicted in Figure 2.[149]

Figure 2. Executive compensation of SVB over the years[150]



Source: Gara, A., Temple-West, P., & Kinder, T. (2023, March 24). Executive pay at Silicon Valley Bank soared after big bet on riskier assets.

Secondly, the CHCC failed to utilise documentation of performance evaluation to guide compensation recommendations.[151] Instead, they relied solely on the CEO's recommendations, a practice which undermined transparency and objectivity within the decision-making process.[152] In interviews conducted by supervisors with SVB, it was revealed that the bank's reluctance to revise the compensation scheme stemmed from the fear of losing its senior executives to rival firms as its compensation was lower than the peer firms. [153]

Additionally, SVB equity compensation has little to no consideration of risk management.[154] For instance, in the 2021 self-assessment, cash bonuses and equity awards were determined based on SVB's ROE.[155] In that year, the cash bonus of then CEO Becker doubled to US$3 million from US$1.4 million in 2017.[156] This was despite SVB falling short on its objective to build the risk-management program to meet Large Financial Institution standards.[157]

Following the Fed's assessment, SVB was required to "develop mechanisms to hold senior management accountable for meeting risk management expectations."[158] SVB responded by proposing enhancements into its performance evaluation process.[159] However, the compensation breakdown for 2022 revealed that a substantial portion of the total compensation awarded to the CEO still consisted of equity awards tied to the bank's financial performance.[160] Furthermore, in 2022, SVB's Chief Risk Officer (CRO), Laura Izurieta, had an unexplained exit from the bank and left SVB without a CRO for eight months.[161] Following her departure, she was also compensated with over US$7.1 million.[162] In particular, in March 2023, executive bonuses for the fiscal year 2022 were still paid out despite the bank's negative cash balance hours before the government takeover.[163]

Working from bed to desk

> "Working in SVB felt more like working at a tech company than it did like working at a bank"
>
> — *A former banker in SVB*[164]

When SVB collapsed in March 2023, 8,500 staff were still working remotely.[165] After the pandemic, which accelerated work-from-home trends, SVB continued to be one of the top 20 US banks that fully embraced the remote working culture, even as bankers in other traditional financial institutions returned to their offices.[166] SVB's enthusiastic adoption of remote working practices extended even to its board meetings.[167] While virtual meetings provide convenience and flexibility, critics argue that adopting a remote setting does not allow for constructive scepticism and inquiry, which are pivotal to effective oversight of the board.[168]

SVB also acknowledged the risk it faced from a prolonged work-from-home arrangement in the annual report.[169] In the report, SVB highlighted possible negative consequences of such arrangements including concerns about systems access, challenges in onboarding new employees, reduced team collaboration, impeded productivity, and disruptions in business operations.[170]

Risk management failure

According to an analysis by the Harvard Business Review, all four lines of defence failed at SVB.[171] The first line of defence includes key decision makers such as the treasurer, CFO and CEO, who made bets on duration risk to increase profitability.[172] It was revealed that the CFO and CEO ignored potential risks and invested in long-term treasuries and MBS to bolster profits,[173] resulting in high durations and significant liquidity mismatch with bank deposits.[174]

The second line of defence is led by the CRO, who provides oversight and monitoring, ensuring that risk levels fall within the risk limit.[175] However, SVB did not have a CRO during a critical period when the bank was incurring massive losses from its investments. Additionally, the RC had no chair in 2022, and none of the RC members had significant risk management experience.[176] Despite regulations mandating banks with assets exceeding US$50 billion to appoint a CRO, SVB did not comply.[177]

The third line of defence is represented by internal audit, which is responsible for providing independent assurance to senior management.[178] Its key role is to ensure effective performance of the first two lines and suggest areas of improvement when necessary.[179] In October 2022, SVB's internal audit function was deemed ineffective, driven by material weaknesses in its risk-assessment process, the process to define internal audit, and continuous monitoring. [180]

The fourth line of defence refers to external assurance provided by regulators and external auditors.[181] In SVB's case, regulators overlooked the absence of a proper risk governance structure despite clear warning signals.[182] Policymakers need to keep banks answerable for ensuring regulatory compliance, yet SVB fell through the cracks despite multiple regulatory bodies and stringent requirements for governance, risk management, capital adequacy, liquidity coverage, and stress testing.[183]

Missing CRO

In April 2022, SVB's then CRO Laura Izurieta resigned, prompting the bank to begin searching for her successor. However, as SVB continued its quest for a new CRO, risks were flooding into the bank. The year 2022 was marked by volatility and uncertainty as interest rates began to rise and venture capitalists slowed their deal-making activities. The leadership gap left the board struggling to manage emerging risks in the portfolio, as well as market and liquidity risks.[184]

During the ongoing search, a committee of senior risk officers assumed responsibility for the RC.[185] However, many of them were "new and still completing baseline assessments".[186] Only one of the seven board members on the RC had relevant risk management experience, and none had previously held senior risk management roles.[187] This inexperience made it challenging for the board to effectively oversee management. To external observers, the SVB's board, management, and risk teams "seemed ill-equipped to handle even a low level of risk, let alone a combination of skyrocketing growth."[188]

Although risk management responsibilities also extended to other functions of the bank, including the finance and treasury department, the absence of leadership within the risk department weakened crucial internal control oversight. It was not until January 2023 that SVB addressed this significant leadership by appointing Kim Olson as the new CRO.[189]

External auditors' "blind" opinion

> "The auditors failed to mention the fire in the basement or the box of dynamite on the first floor, but they did point out the peeling paint on the flower box,"
>
> *– Erik Gordon, University of Michigan business professor*[190]

Prior to the collapse of SVB, its external auditor, KPMG LLP, issued an unqualified audit opinion on 24 February 2023.[191] However, the bank collapsed just weeks later. In the letter addressed to SVB shareholders, KPMG stated that SVB's financial statements were presented fairly and in accordance with Generally Accepted Accounting Principles (GAAP).[192]

KPMG did not highlight any concerns related to risk management at SVB. The bank's financial statement reported that the fair value of its HTM securities were US$15.1 billion below its balance sheet values,[193] almost as large as the bank's total equity of US$16.3 billion.[194] SVB maintained the position that it was able to hold these bonds to maturity. KPMG should have identified doubts about SVB's ability to hold these bonds to maturity, but this was absent in the audit report. Martin Baumann, formerly the Chief Auditor at the Public Company Accounting Oversight Board (PCAOB), mentioned that SVB's unrealised losses in its bond portfolio fulfilled every criterion indicative of a potential critical audit matter.[195]

Additionally, SVB's deposits fell by US$25 billion in the last nine months of 2022, potentially affecting the bank's liquidity.[196] In February 2023, SVB also experienced a concerning amount of deposit outflows.[197] Both of these developments should have been highlighted by KPMG as potential signs of a bank run. The omission of such critical disclosures may subject KPMG to regulatory scrutiny and potential lawsuits.[198]

Just following disclosures?

According to SVB's corporate governance guidelines, the board and the RC oversee the company's risks and manage its risk appetite framework.[199] Alongside other committees, the board also supervises the company's risk appetite statement, which outlines the risk tolerance levels for both the amount and types of key risks inherent in SVB's business.[200] The risk appetite statement also provides guidance and limits on the types of risks the company is willing to take on when pursuing business and strategic objectives. Additionally, there is a governance framework outlining the oversight role of the board and RC, the management's risk management responsibilities, and the reporting process when there is non-compliance.[201] The RC is required to oversee enterprise-wide risk management policies, ensure that SVB complies with the risk appetite statement, monitor any changes to SVB's risk profile, and escalate any matters of concern to the board for discussion and potential action. [202]

Despite extensive guidelines on paper, the Fed highlighted SVB's inability to align risk management processes with the bank's tremendous growth.[203] It highlighted that the board did not obtain sufficient information about risks at SVB and failed to hold management accountable for risk management.[204] In addition, the board prioritised short-term profits over sound risk management, glossing over supervisory issuers for compliance's sake. The bank also did not pass internal liquidity stress tests and had no plans to access liquidity in times of stress.[205]

Was risk management sufficient?

The inadequate risk management within the bank has resulted in ineffective risk identification and a lack of meaningful responses to these risks.

Firstly, the risk assessment framework adopted by SVB to measure interest rate risk was rudimentary and did not evolve as the bank grew tremendously in size.[206] In addition, issues related to interest rate risks were not being reported to the Asset/Liability Management Committee (ALCO), which is responsible for managing these risks.[207]

Secondly, in response to breaches in the economic value of equity (EVE), SVB simply made model changes that reduced the risk portrayed by its model instead of addressing the core issues on its balance sheet.[208] These changes were allegedly pushed by Beck and backed by the approval of ALCO despite several mid-level bank officials expressing discomfort with the decision.[209] Since 2017, SVB had also breached long-term interest rate risk limits due to the structural mismatch between long-duration securities and short-duration deposits.[210] Rather than addressing this risk, SVB made counterintuitive modelling assumptions about the duration of deposits.[211] Over the same period, SVB removed interest rate hedges that could have protected them against rising interest rates in pursuit of short-term profits.[212]

Lastly, deposit pressures eroded SVB's liquidity position in 2022, yet the company was slow to react.[213] In the third quarter, despite significant shortfalls in liquidity, the assessment of liquidity risk management practices was said to be improving.[214] It was only in the fourth quarter of 2022 that management recognised liquidity risk and began to take substantial measures to restructure the balance sheet to address the deposit trends and financial risks facing SVB.[215]

Regulators need regulating

Following the 2008 Global Financial Crisis, the EPS were established for large financial institutions as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[216] Banks with total assets exceeding US$50 billion were subject to EPS which included requirements related to liquidity, capital, stress testing, and resolution planning.[217] However, in 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) was enacted to raise the threshold for EPS from US$50 billion to US$ 250 billion, thereby excluding smaller to medium sized banks like SVB and subjecting them to less stringent measures.[218] Consequently, despite having over US$200 billion in total assets as of 31 December 2022, SVB was not subject to these additional regulations.[219]

Consistent with the EGRRCPA, in October 2019, the Federal Reserve Board (FRB) established the Tailoring Rule which further refined and categorised the application of the EPS to large US banking organisations and foreign banking organisations. The Tailoring Rule established different categories (I-IV) for banking organisations based on their size and risk factors, with each category subject to varying levels of EPS. Banks in categories I and II included the largest and most complex banking organisations, which remained subject to the most stringent standards. In contrast, banks in categories III and IV faced less stringent set of EPS.[220] Before its collapse, SVB was qualified as a Category IV bank, with total assets between S$100 billion and US$ 250 billion.[221]

Following the 2019 Tailoring Rule, the burden of proof was placed more heavily on regulators to determine the effectiveness of company's corporate governance policies.[222] As such, critics of the tailoring regulations opine that central to SVB's collapse was this shift of supervisors' roles - from raising and acting on matters requiring attention to simply filing reports.[223]

Had these changes not been made to the framework, SVB would have been subjected to enhanced liquidity risk management requirements, full standardised liquidity requirements (i.e., liquidity coverage ratio and net stable funding ratio), enhanced capital requirements, company-run stress testing, supervisory stress testing at an earlier date, and tailored resolution planning requirements.[224]

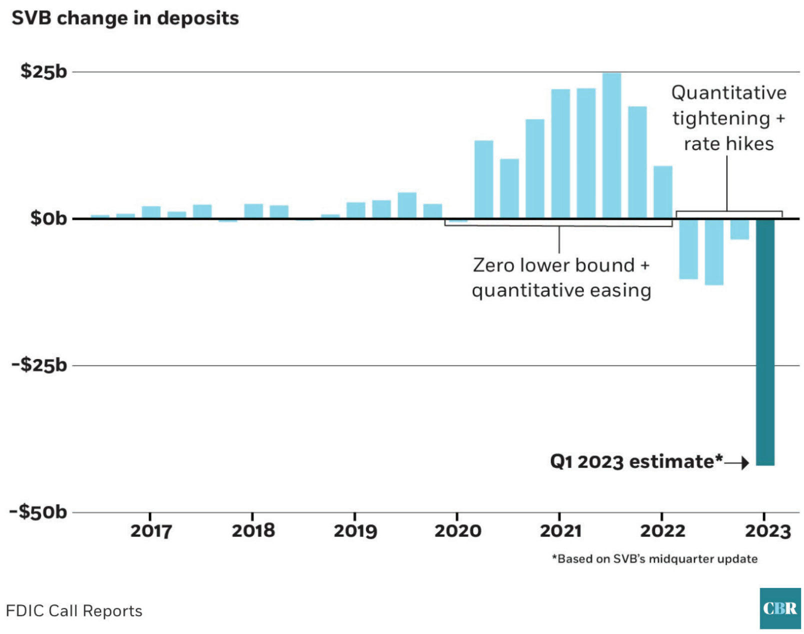
Inadequate management of institutions' compliance

As SVB's problems began to pile up over 2021 and 2022, the Fed issued Matter Requiring Attention (MRA) to SVB with specified time frames for resolutions.[225] However, the Fed did not penalise SVB - leaving no incentive for the bank to address the issues raised.[226] Moreover, these warnings were delayed, as the key risks identified had already been ingrained in SVB's risk management functions.[227] This was further compounded by the shortage of staff in the Fed and FDIC with the competence to oversee more complex institutions like SVB.[228]

Another player to blame?

The rise in deposits at SVB was also driven by quantitative easing measures by the Fed.[229] As quantitative easing continued throughout the pandemic until 2022, deposit inflows observed at SVB almost tripled compared to inflows in 2019 as shown in Figure 3. However, in 2022, as quantitative tightening measures began to replace quantitative easing, deposit outflows were observed.[230]

Figure 3: SVB's change in deposits (2017-2023) [231]



Source: Rajan, R. G., & Acharya, V. (2023, May 25). Did the Fed contribute to SVB's collapse?

Moreover, quantitative tightening and rate hikes from 2022 to 2023 were of greater magnitude and more sudden than before. The losses on banks' assets were more substantial as the quantity of interest-sensitive securities held by US banks was higher. The FDIC identified losses exceeding US$600 billion on AFS and HTM securities. This shows that the Fed and other regulators are arguably not completely blameless in the collapse of SVB.[232]

Can we prevent another SVB collapse?

On 12 March 2023, the Fed created the Bank Term Funding Program (BTFP) aimed at safeguarding institution affected by the collapse of SVB.[233] The Fed announced that it will make additional funding available to ensure banks have the ability to meet the needs of all their depositors.[234] Under this program, banks are enabled to borrow unlimited amounts from the Fed from March 2023 to March 2024, on the condition that the loans are matched by safe government securities.[235] This acts as an additional source of liquidity, allowing banks to protect themselves from run-on deposit without having to crystallise current mark-to-market losses on higher quality assets, thus boosting depositors' confidence.[236]

Increased insurance on deposits

Additionally, SVB's banking failure has spurred more serious discussions on raising FDIC insurance cap. Upon further study, FDIC data showed that "many banks have deposits above the current US$250,000 insurance threshold".[237] SVB was not the only one with above-average uninsured deposit levels - giant banks such as J.P. Morgan and Citibank also have a majority of uninsured deposits (59% and 85% respectively).[238] However, changes are unlikely to be implemented in the foreseeable future due to the bipartisan agreement required in Congress.[239]

Another key change is a potential increase in the DIF. The DIF stood at around US$125 billion as of March 2023, whereas SVB had US$175 billion in deposits at the end of 2022 before the collapse.[240] Banks made contributions to the DIF in proportion to their size. Should the DIF increase, larger banks would feel the impact more significantly, and as a result, customers would suffer.[241] Some analysts further argue that full deposit insurance should be implemented.[242] Nevertheless, regulators must assess whether implementing such a policy could potentially encourage further recklessness from the banks.[243]

Tightening the leashes on banks

The Fed Vice-Chairman for supervision, Michael Barr and the FDIC Chairman, Martin Gruenberg have highlighted a high likelihood of tightening regulatory requirements for banks possessing US$100 billion to US$250 billion in total assets.[244]

Furthermore, regulators are likely to renew regulations over incentive compensation as they consider whether the programs at the failed banks inappropriately incentivised excessive risk taking. Anticipated new rules that are likely to surface may involve mandating incentive pay deferrals and stringent clawback rules requiring a more vigilant oversight by the board and compensation committee.[245]

Following the SVB collapse, banks can also expect other changes. Firstly, supervisors may implement alternative types of foundational exams and more forward-looking analyses to enhance risk identification.[246] Secondly, supervisors may reconsider regulatory capital assessments to more precisely identify interest rate risks and other risks to allow banks to prepare adequate support for potential shocks.[247] Thirdly, the supervisory culture may evolve over time to place a greater emphasis on inherent risk and exhibit a greater willingness to form judgments that challenge bankers with a precautionary perspective. [248] Lastly, the current oversight program may be reduced in complexity to improve the effectiveness of supervision of banks by increasing supervisors' bandwidth in conducting stronger fundamental risk analysis.[249]

The aftermath

A class action lawsuit was filed against SVB Financial Group, former CEO Becker, and former CFO Beck for failing to disclose the significant interest rate risks the company was facing.[250] The class lawsuit, led by shareholder Chandra Vanipenta, claimed that SVB's quarterly and annual financial reports did not fully account for warnings from the Fed regarding interest rate hikes.[251] It alleged that the annual reports from 2020 to 2022 downplayed the risks SVB faced by not disclosing the potential adverse impacts of the highly anticipated interest rate hikes outlined by the Fed. Such omissions had the potential to inflict irrevocable harm to SVB.[252]

First Citizen's acquisition

> "Since First Citizens purchased SVB, uncertainty has been largely diminished,"
>
> – *Ben Scruggs, CEO of Altis Biosystems in Research Triangle Park*[253]

After the acquisition of SVB's failed remains, First Citizens Bank's share price has increased by more than 53%.[254] The UK arm of SVB that was absorbed into HSBC's operations has now been transformed into HSBC Innovation Banking, proposed to support innovation businesses and their investors globally.[255]

Regulatory reform gridlock?

> "It's going to really set the stage for regulatory reform,"
>
> – *Derek Tang, Economist at LH Meyer/Monetary Policy Analytics*[256]

With four other banks in the US failing after the collapse of SVB, stakeholders such as Congress and the White House are beginning to place greater pressure on regulators to perform.[257] Banks can expect a suite of changes around risk management, including the frequency and scope of stress tests to be conducted.[258]

Will the necessary reforms be made to prevent another collapse like SVB? While the industry can expect more stringent supervision by regulators in the US, significant legislative changes may be unlikely to occur due to the bipartisan requirements in Congress.

Discussion questions

1. What were the key contributory factors leading to SVB's collapse, and how did SVB's business model and strategy play a role? Rank them in order of significance and explain.
2. Reflecting on SVB's experiences in the context of the Dotcom Bust and the 2008 Financial Crisis, what key lessons should the bank have learned to mitigate the collapse in 2023? How might these lessons have altered the bank's strategies and decisions?
3. Critically evaluate SVB's responses to warnings issued by the Federal Reserve. From a corporate governance standpoint, were these responses appropriate? How could they have been improved?
4. Evaluate SVB's risk management policies and their effectiveness within the context of the 'Three Lines of Defence' model. What specific risks did the bank face, and which line of defence contributed the most to SVB's eventual failure? How could the bank have managed these risks better?
5. Analyse the structure and practices of SVB's board of directors. What red flags were present that may have contributed to the bank's downfall? What strategies can banks employ to ensure they have suitable directors and committees to address business needs?
6. Were the responses of US regulators appropriate and adequate both before and after SVB's collapse? Discuss any areas where regulatory actions fell short and propose potential improvements.
7. Compare and contrast the regulatory environments for financial institutions in Singapore and the US. Should regulators in Singapore also consider tightening regulations for financial institutions, and if so, in what areas?

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Professor Mak Yuen Teen is the founding director of the Centre for Investor Protection. He is Professor (Practice) of Accounting at the NUS Business School and a former Vice Dean of the School, where he founded the first corporate governance centre in Singapore at NUS. Professor Mak holds first class honours, master and PhD degrees in accounting and finance. He is a member of the Institute of Singapore Chartered Accountants (ISCA).

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Professor Mak has served on three of the four corporate governance committees set up by the Singapore authorities to develop and revise the code of corporate governance for listed companies, including the first committee in 2000 and the most recent committee under the Monetary Authority of Singapore (MAS) which released the 2018 Singapore Code of Corporate Governance. He is currently serving a second three-year term on the Corporate Governance Advisory Committee under MAS aimed at continually raising corporate governance standards for listed companies in Singapore.

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Professor Mak was a former council member of the Singapore Institute of Directors. He is a director of a new not-for-profit company set up to enhance investor protection and education in Singapore called Corporate Monitor Limited. He serves as a member of the Advisory Council of the Vietnam Independent Directors Association and as a member of the International Advisory Board of the Hawkamah Institute of Governance in Dubai.

Professor Mak is actively involved in conducting training on corporate governance for directors and regulators in the region and speaks regularly in international conferences. He is the advisor of a new director programme introduced by ISCA and SAC Capital, which has been accepted the Singapore Exchange as an alternative for fulfilling the mandatory training requirements for first-time directors of companies listed in Singapore.

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Professor Mak edited 11 volumes of Asia-Pacific and global case studies published by CPA Australia between 2012 and 2022 and a special financial services edition, and several volumes translated into Chinese and Vietnamese have been produced. In all, he has written or edited more than 250 case studies related to corporate governance.

Professor Mak developed the first corporate governance rating for Singapore companies and the first Singapore governance rating for REITs and business trusts. He was nominated by MAS as the Singapore expert in the development of the ASEAN CG Scorecard.

He has also produced numerous reports on corporate governance. In 2007, his report on improving the implementation of corporate governance practices in Singapore, commissioned by MAS and the Singapore Exchange, was launched by the Minister of Finance at the OECD Asian Corporate Governance Roundtable held in Singapore.

Professor Mak is one of only two individuals in Singapore to have been given the Corporate Governance Excellence Award by the Securities Investors Association (Singapore) for his contributions to improving corporate governance in Singapore. The Singapore Institute of Directors has also recognised him as a CG Pioneer. He also received the corporate governance excellence award from the Minority Shareholders Watchdog Group in Malaysia for his contributions to corporate governance in the region.

He is a strong corporate governance advocate and comments regularly on current corporate governance issues on LinkedIn and on his personal website, Governance for Stakeholders, which he started in 2013.

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Koh Yan Qi is an alumnus of the National University of Singapore Business School, holding a Bachelor of Business Administration (Accountancy) with Honours (Highest Distinction). Passionate about exploring new places, she enjoys travelling, cafe hopping, and participating in barre and pilates workout classes at different studios. She frequently visits her hometown in Malaysia, where she relishes the local cuisine and the slower pace of life while spending quality time with her family. On weekends, she loves catching up with close friends, exercising, and watching Korean dramas.

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ISBN 978-9-81-940695-1

9 789819 406951

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