The Institute of
Internal Auditors
Elevating Impact

December 5, 2022

The Honorable Sherrod Brown
United States Senate
503 Hart Office Building
Washington, DC 20510

The Honorable Patrick Toomey
United States Senate
455 Dirksen Office Building
Washington, DC 20510

The Honorable Debbie Stabenow
United States Senate
731 Hart Office Building
Washington, DC 20510

The Honorable John Boozman
United States Senate
141 Hart Office Building
Washington, DC 20510

The Honorable Maxine Waters
United States House of Representatives
2221 Rayburn Office Building
Washington, DC 20515

The Honorable Patrick McHenry
United States House of Representatives
2004 Rayburn Office Building
Washington, DC 20515

The Honorable David Scott
United States House of Representatives
468 Cannon Office Building
Washington, DC 20515

The Honorable Glenn "GT" Thompson
United States House of Representatives
400 Cannon Office Building
Washington, DC 20515

RE: Recommendations for Enhancing Corporate Governance at Cryptocurrency Exchanges

Dear Chairman Brown, Chairwoman Stabenow, Chairwoman Waters, Ranking Member Toomey, Ranking Member McHenry, and Ranking Member Thompson:

On behalf of The Institute of Internal Auditors (The IIA), the international professional association representing approximately 218,000 internal auditors,[1] I write to encourage congressional consideration of new requirements designed to bolster corporate governance at cryptocurrency exchanges operating in the United States.

The recent Chapter 11 bankruptcy filing of FTX, once the third-largest cryptocurrency exchange,[2] reveals the devastating impact on American consumers when companies lack sufficient internal controls and fail to provide objective assurance over those controls. Although the full magnitude

[1] "About Us," The Institute of Internal Auditors: https://www.theiia.org/en/about-us/

[2] "FTX head Sam Bankman-Fried's downfall sends shockwaves through cryptocurrency," *The Associated Press*, November 14, 2022: https://www.pbs.org/newshour/nation/ftx-head-sam-bankman-frieds-downfall-sends-shockwaves-through-cryptocurrency

of the FTX collapse has not yet been fully quantified, preliminary court filings estimate more than one million customers suffered direct financial losses.[3]

The opaque and poorly defined governance model at FTX, according to media reports, allegedly enabled the company to conceal financial improprieties, including:

- A potentially improper transfer of $10 billion in customer funds from FTX to an affiliated hedge-fund named Alameda Research
- Approximately $1 billion to $2 billion in missing customer funds
- Creation of a "backdoor" accounting system designed "to execute commands that could alter the company's financial records without alerting other people, including external auditors."[4]

John Ray III, the newly appointed CEO of FTX, bluntly confirmed these alleged internal control failures in a U.S. Bankruptcy Court filing:[5]

> *Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here. From compromised systems integrity and faulty regulatory oversight abroad, to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, this situation is unprecedented.*

Since FTX is privately held, the company was not required to comply with certain provisions of the Sarbanes-Oxley Act of 2002 (SOX) intended to promote sound internal controls over financial reporting and provide transparency to the investing public and accountability from corporate leaders. As you are aware, SOX mandates, in relevant part:[6]

- It is the responsibility of management to establish and maintain an adequate internal control structure and procedures for financial reporting
- Annual assessments, certified by management, confirming the effectiveness and appropriateness of internal controls

Unfortunately, since most cryptocurrency exchanges are not subject to SOX compliance, consumers were denied basic organizational transparency and did not possess relevant information to assess investment risk.

In addition, the absence of a robust internal audit function at FTX prevented the identification and adequate mitigation of multiple material risks. The purpose of internal audit, as you are aware, is to provide a board of directors with objective assurance, insight, and advice that is <u>independent from management</u>.[7]

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[3] "FTX says it could have over 1 million creditors," Ryan Browne, *CNBC*, November 15, 2022: https://www.nbcnews.com/tech/crypto/ftx-says-1-million-creditors-rcna57245

[4] "Exclusive: At least $1 billion of client funds missing at failed crypto firm FTX," Angus Berwick, *Reuters*, November 13, 2022: https://www.reuters.com/markets/currencies/exclusive-least-1-billion-client-funds-missing-failed-crypto-firm-ftx-sources-2022-11-12/

[5] "Declaration of John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings," U.S. Bankruptcy Court for the District of Delaware, November 17, 2022: https://pacer-documents.s3.amazonaws.com/33/188450/042020648197.pdf

[6] "Corporate responsibility for financial reports," 15 U.S. Code § 7241: https://www.law.cornell.edu/uscode/text/15/7241

[7] "About Internal Audit," The Institute of Internal Auditors: https://www.theiia.org/en/about-us/about-internal-audit/

The existence of an independent and properly resourced internal audit function enhances the value of an organization and strengthens its credibility with stakeholders. Specifically, internal audit supports a board of directors in the evaluation and understanding of:

- Effective governance, risk management, and control
- Responsible decision-making and oversight
- Sustainable value creation and protection
- Accountable stewardship of assets and reputation

The independent role of the internal audit profession is articulated in The IIA's Three Lines Model (TLM). The TLM clarifies specific roles and responsibilities among an organization's leadership (i.e., governing body, management, and internal audit function) to promote strategic and operational alignment, proper oversight, and independence of the internal audit function.

The current situation at FTX only underscores the value of and need for internal auditing as a critical safeguard when investors' money is at stake. It is imperative for organizations – specifically those involved in securities and assets trading – to possess a clearly defined governance structure (as articulated by the TLM), and an independent function within the organization identifying excessive risk and potential control failures. Such a paradigm helps ensure sound business operations, strengthens consumer protections, and best serves the public interest.

Based upon the preliminary lessons learned from the FTX collapse, The IIA respectfully requests congressional consideration of the following recommendations to promote transparency among cryptocurrency exchanges:

- Require all cryptocurrency exchanges operating in the United States, as well as affiliated partners, to possess a sufficiently resourced and highly qualified internal audit function, independent from management and reporting to an audit committee of the board or directly to the full board of directors. Such a mandate would help to promote confidence and transparency in cryptocurrency exchanges' operations and would be similar to The New York Stock Exchange's requirement that its registrants maintain an internal audit function.[8]

- Require the senior management of cryptocurrency exchanges operating in the United States to certify, annually, that their exchanges' internal controls are adequate and appropriate based upon an independent internal audit assessment. Such certifications should also note any identified shortcomings and be transmitted and filed with a federal oversight body (i.e. the Securities and Exchange Commission or the Commodities Future Trading Commission) as yet to be determined by Congress. Such a certification will increase corporate accountability and ensure that robust internal controls are a priority at crypto exchanges operating in the United States.

The IIA believes these recommendations are an important step in establishing greater confidence in the cryptocurrency market and appreciates your consideration of our views.

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[8] "NYSE Listed Company Manual," Section 303A.00, The New York Stock Exchange: https://nyse.wolterskluwer.cloud/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D--WKUS_TAL_5667%23teid-66

Should you have any questions or concerns regarding these policy proposals, or if we can be of any assistance in the development of relevant legislation, please contact Michael Downing, Advocacy Director, at Michael.Downing@TheIIA.org.

Respectfully,

Anthony J. Pugliese, CIA, CPA, CGMA, CITP
President and Chief Executive Officer
The Institute of Internal Auditors

cc: Members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs
Members of the U.S. Senate Committee on Agriculture, Nutrition, and Forestry
Members of the U.S. House Committee on Financial Services
Members of the U.S. House Committee on Agriculture