Crypto Corner

A review of developments and trends in digital asset markets

Crypto Regulatory Update: The SEC is getting aggressive

Gary Gensler and the SEC hit the ground running in 2023 announcing new charges regarding securities violations for several significant exchanges as well fining celebrity endorsers. This has been accompanied by a new proposal by the regulator that requires investment advisors to use only a qualified custodian for client assets – a move that would slow if not impede capital flow into digital assets. At its surface, this does make some sense as it should in theory protect investors from fraud which is why it received a 4/1 vote in favor of passing. The single opposing vote was cast by Hester Peirce, a well-known crypto advocate since her appointment to the SEC in early 2018.

Peirce's concern is that the onerous and possibly overzealous regulation may serve as a deterrent for the industry as opposed to a protective landscape for investors. Further, she states that rather than protecting investors, restricting the number of viable crypto currency custodians in the US may have a negative impact on the industry by consolidating and centralizing crypto market activities to only a handful of government friendly entities.

Any word from Congress?

All recent enforcement actions have come from the SEC despite a lack of new legislation from Congress on the digital asset industry. This means that the SEC is using enforcement actions in order to make an example out of what they believe to be malfeasance and misfeasance.

Why is the SEC acting now?

The typical pattern for greater regulatory scrutiny is usually reactive to a negative event, just as what happened post dot com bubble in 2001 and post GFC in 2009. The FTX collapse damaged the digital asset industry reputation and even extended beyond to unaffiliated parties. Preceding the FTX collapse there was lax supervision and oversight because regulators and law makers simply did not have the knowledge and tools in place to address the types of problems presented in the digital asset space. In addition, the SEC was closely acquainted with FTX prior to collapse. Nobody is pointing fingers or discussing Gary Gensler's role in the oversight of FTX, but the optics do not look good, and this likely contributes to the more aggressive reaction from the SEC.

Recent notable SEC enforcement action

The SEC has called all "staking services" unlicensed securities, under the Howey Test. Staking is a service offered by most crypto exchanges that allow traders to lend tokens to an exchange in order to earn interest. The key concern is that in the event of financial turbulence, exchanges may seize staked tokens as company assets. This has happened in the Gemini earn program at the end of 2022, as the parent company Gemini was wiped out due to affiliation with FTX.

It is strange that as opposed to targeting exchanges that already went bust and confiscated depositors' assets, such as Gemini or Celsius, an example is made of exchanges with staking services like Kraken and Coinbase - which are among the most reputable US exchanges.

This could become painful, as Coinbase reports 11% of net revenue in Q3 2022 from staking activities. Coinbase has already commented on the settlement between Kraken and the SEC by proclaiming that the staking services they offer are above board, do not qualify as securities, and the exchange has no plans to shut down its staking services.

Are crypto exchanges and technologies moving overseas?

The Hong Kong securities and Futures Commission (SFC) has moved to create regulations for cryptocurrencies, as opposed to outright bans or shutting down of exchanges like the SEC has. The SFC has published a set of proposed rules for exchanges which it states it would seek to amend after seeking public comment. Many believe, such as Hester Peirce, that as more Asian countries, which had previously been opposed to crypto, change their tune it could draw both talent and capital away from the US. Interestingly, even with mainland bans on crypto currencies in China, there has yet to be a negative reaction from the Chinese government regarding Hong Kong's announcement. Rumors are that they view Hong Kong as a market test pilot for new crypto trading and blockchain technologies. Stay tuned…

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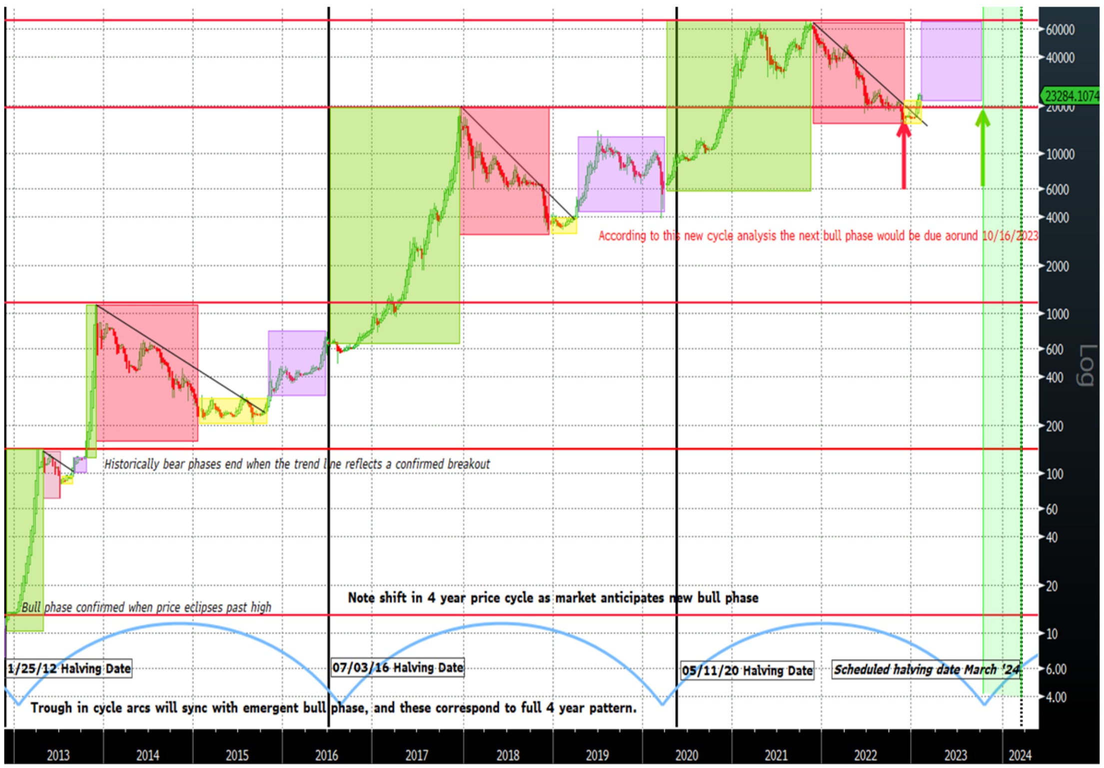
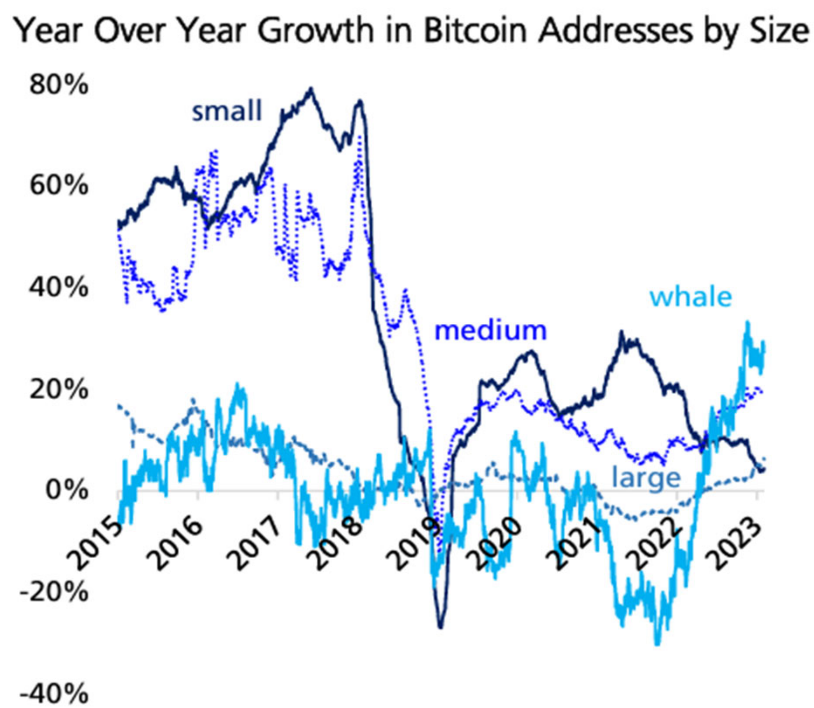
Positive changes noted in BTC network

Notably, despite regulatory action, the top 12 crypto currencies by market cap, have seen only modest declines in returns, in the single digits and following a 60% run up in the beginning of the year. However, Bitcoin price is very sensitive to changes in the money supply, the level of real interest rates, and high yield debt spreads. The macro economic landscape is that the money supply continues to contract, the Fed is looking to keep rates "higher for longer," and historically higher credit spreads follow Fed tightening cycles. Still, if BTC price can hold above ~$20,000 support it would provide additional strong evidence of an end to the bear market phase, and entrance of an accumulation phase as discussed in the January research note. Furthermore, address growth, a measure of network size, grew by an estimated 10%. Large investors – addresses with greater than 10,000 BTC ($222MM) aka "Whales", constitute the bulk of that address growth. Metcalf's law estimates a growth in fundamental value of ~20% with that level of network growth. *Clearly, Bitcoin continues to garner institutional interest despite the adverse conditions and a weakening macro economic back drop – a positive development.*





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BTC Seasonals

Seasonally, spring corresponds with stronger performance from Bitcoin, per the 10Y average returns displayed below. March returns reflect that the market has already moved to incorporate address growth for 2022. The growth in network size and other positive fundamentals that occurred through 2022 were obscured by the bear price phase that corrected price from overvalued to what is now, most likely, closer to fairly valued conditions.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
10 Yr Avg	.98	14.03	12.32	15.59	11.21	-.71	9.99	3.57	-6.22	23.77	47.45	7.93
2023	38.76	.86	20.89									
2022	-17.04	8.37	9.87	-16.24	-17.08	-41.07	27.10	-15.17	-3.82	5.05	-16.18	-3.30
2021	12.43	38.79	30.30	-3.64	-35.42	-5.74	20.11	13.16	-7.60	40.38	-6.29	-18.91
2020	30.68	-7.71	-24.93	36.18	7.69	-3.77	24.04	2.93	-8.32	29.36	39.92	49.63
2019	-7.00	11.28	7.64	27.97	62.34	33.98	-11.99	-3.99	-14.39	11.51	-16.10	-7.16
2018	-29.06	5.78	-34.97	35.32	-18.70	-21.74	30.34	-8.39	-6.86	-3.95	-37.64	-6.52
2017	1.02	24.02	-9.89	26.18	68.59	9.47	15.35	64.25	-12.02	52.89	27.55	72.64
2016	-12.69	15.01	-3.93	9.19	14.63	27.51	-5.00	-9.43	5.87	15.87	5.85	28.09
2015	-27.63	10.97	-4.21	-3.10	-2.03	12.59	9.09	-19.07	2.86	36.39	16.58	14.68
2014	8.01	-29.72	-17.84	-3.76	36.97	5.38	-9.37	-18.19	-18.77	-12.14	9.75	-15.54
2013	51.07	63.55	171.12	47.79	-4.90	-23.75	.27	29.58	.85	62.36	451.03	-34.31

-41.07 451.03

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