ONERIVER DIGITAL
ASSET MANAGEMENT

market notes: Destructive Ambiguity in Regulation

09 DECEMBER, 2022

Regulatory clarity is THE issue in the digital economy. You don't need to be a lawyer to follow the money and realize the importance of the Travel Rule, the Bank Secrecy Act, State Trusts, Qualified Custodians, and UCC. The period of destructive ambiguity has passed.

Marcel Kasumovich, Deputy CIO, One River Digital

1. “Had we over-regulated the Internet early on, we would have missed out on many innovations that we can’t imagine living without today. The same is true for blockchain. Disruptive technologies rarely fit neatly into existing regulatory considerations, and rigid regulatory frameworks have repeatedly stifled innovation. It’s likely that innovations in the Blockchain will outpace policy, let’s not slow it down.” Brookings Institution made this declaration in 2015. It is time to heed those wise words.

2. But it’s money. The stakes are higher. That digital assets have lived to see their fifth bear market is already an achievement. Liberty Reserve is a reminder of how hard it is to survive. Regulatory clarity is THE issue. It’s not easy. It’s especially hard for technology built to shred powerful middlemen. Be attentive to the resilient components of the ecosystem. They matter most in disruptive downturns. Those are the building blocks. Today, it is Bitcoin, Ethereum, and Stablecoins – more than two-thirds of the market cap (Figure 1). Tomorrow, it will be the things built on those foundations.

3. Discussions on regulation are met with a natural first response: I’m not a lawyer. You don’t have to be. Follow the money. That trail will tell you a lot about regulatory policy and compliance. Where are my assets? Most investors want to spend time focused on price risk and portfolio construction, not operational ones. Yet, the digital financial crisis has investors reasonably going back to the basics: Custody, the foundation for institutional scale.

4. “Self-custody.” Aren’t digital assets about bringing users control? Yes, to a point. The concept of unhosted wallets, or “self-custody," removes counterparty risk entirely. It pushes all the risk to the investor. The user controls the keys, and thus, the assets. For individuals, this can be a powerful tool. The keys are used to identify your place on the blockchain. However, lose the keys, and you lose your assets. It also introduces various regulatory issues, such as the Travel Rule for money under the Bank Secrecy Act. Unhosted wallets need to adhere to these rules to avoid illicit activity.

5. But unhosted wallets are not institution friendly. “The investor” in this case is an institutional machine. Private keys can be broken into pieces. To unlock assets requires an entire key, and diversity of the pieces can ensure security. Phrases can be stored in multiple places. Unhosted wallets could be widespread. But this isn’t where institutions start. Reasonably. State Street. BNY Mellon. These are familiar custodial arrangements and native digital players need to come as close as possible to replicating them. And they have.

6. Demand for hosted, third-party custody solutions has mirrored that of institutional interest in digital assets. Figure 2 illustrates industry players in custodial solutions over time. There’s a surge in 2018, just after the super-spike in digital assets in 2017. In the most recent cycle, traditional banks were drawn

Private and Confidential: Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited.

to provide custodial support, just in time for the peak in 2021 asset prices. The solutions are there, but not all are created equal. And investors would like tools familiar to traditional markets.

7. "Qualified custodian" is one of those familiar elements. Digital custodians were attracted to this standard. But there's an issue – it is defined by the Custody Rule, regulated by the SEC, and there appears no urgency to provide clarity for digital assets. Entities seeking regulatory clarity found creative solutions through State Chartered Trust Companies. Independently capitalized. Segregated assets. 100% reserved. Deep cold storage solutions. In 2018, digital "qualified custodians" were led by the New York State Department of Financial Services. It is an institutional standard.

8. Yet, there are roadblocks imposed by regulators. The Staff Accounting Bulletin No. 121 took banks out of the custody business. "The staff believes that Entity A should present a liability on its balance sheet to reflect its obligation to safeguard the crypto-assets held for its platform users." Traditional custody is off balance sheet. Custodial services are uneconomic as banks are capitalized to gross balance sheets. A win for digital custodians? Not quite. The Bulletin required disclosure that custodial assets may not be protected in bankruptcy, adding uncertainty rather than clarity.

9. Pulling on the disclosure thread takes us down another regulatory path – the Uniform Commercial Code (UCC) that governs all US commercial transactions. Digital assets do not fit neatly into UCC. We learned the same with our Digital Income strategy. And there has been little effort to provide clarity to date. Service providers are now spelling it out for users. Agreements are being updated to state the applicability of UCC Article 8. That article implies custodial assets are bankruptcy remote from general creditors. This is the same legal protection offered in traditional asset markets.

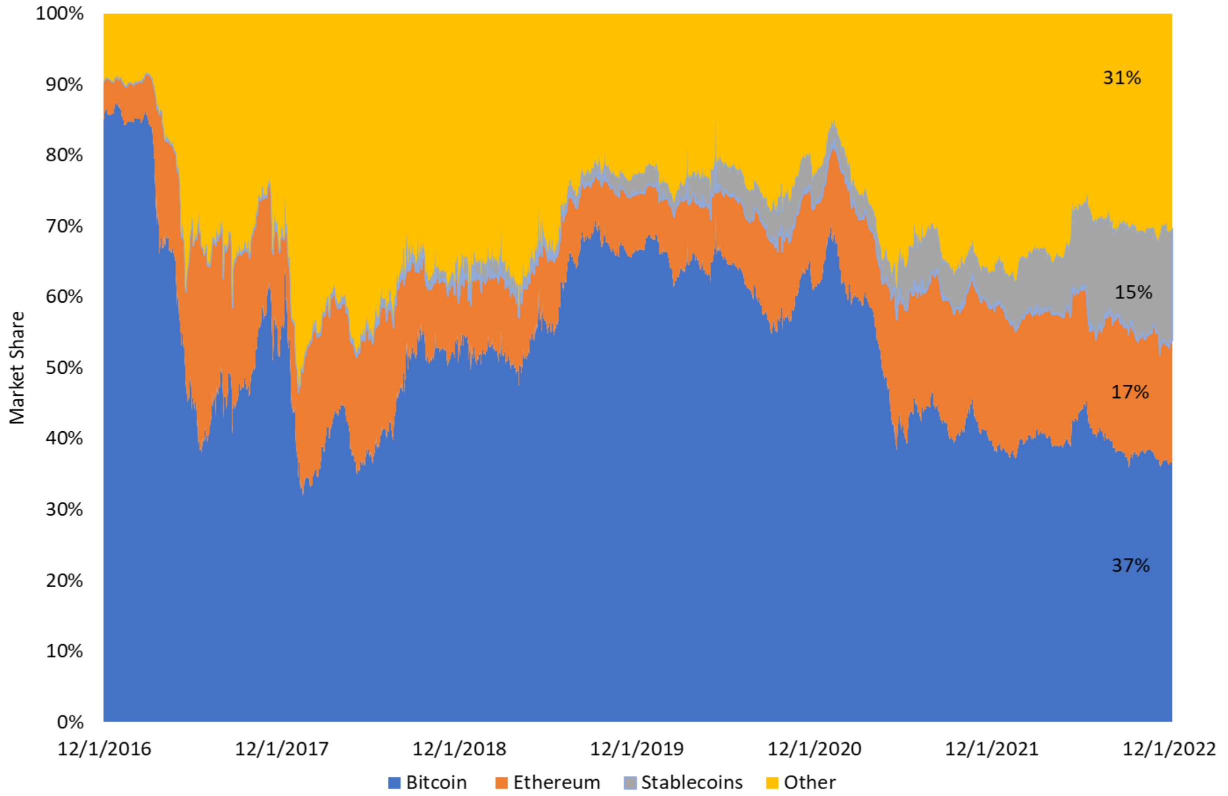
10. Clarity is being realized by enforcement. The wave of bankruptcy is bringing clarity to custody issues – Celsius's segregated customer assets are being returned to the customer. And precedent is being set on the value of regulatory clarity. LedgerX, a derivative intermediary, was part of the FTX family and excluded from the bankruptcy filing. It has been subject to CFTC regulatory oversight since 2017. Simple things followed. Communication lines between LedgerX and the CFTC. Capital requirements to meet operating costs. Segregation of client assets. Regulation worked.

11. Don't let any crisis go to waste. The transformative potential of digital assets is driven by their resiliency – the foundations can't be easily killed. Big thinkers on money, like Hayek, contemplated the issues holistically. When in doubt go back to those. Hayek's thinking was simple – competition is good. Why should money and its regulations be different? Hayek evaluated innovation in the

Private and Confidential: Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited.

monetary sector through digital currencies long before their existence. His last revision on the topic was in 1990, at the age of 91. Life is long. Live it.

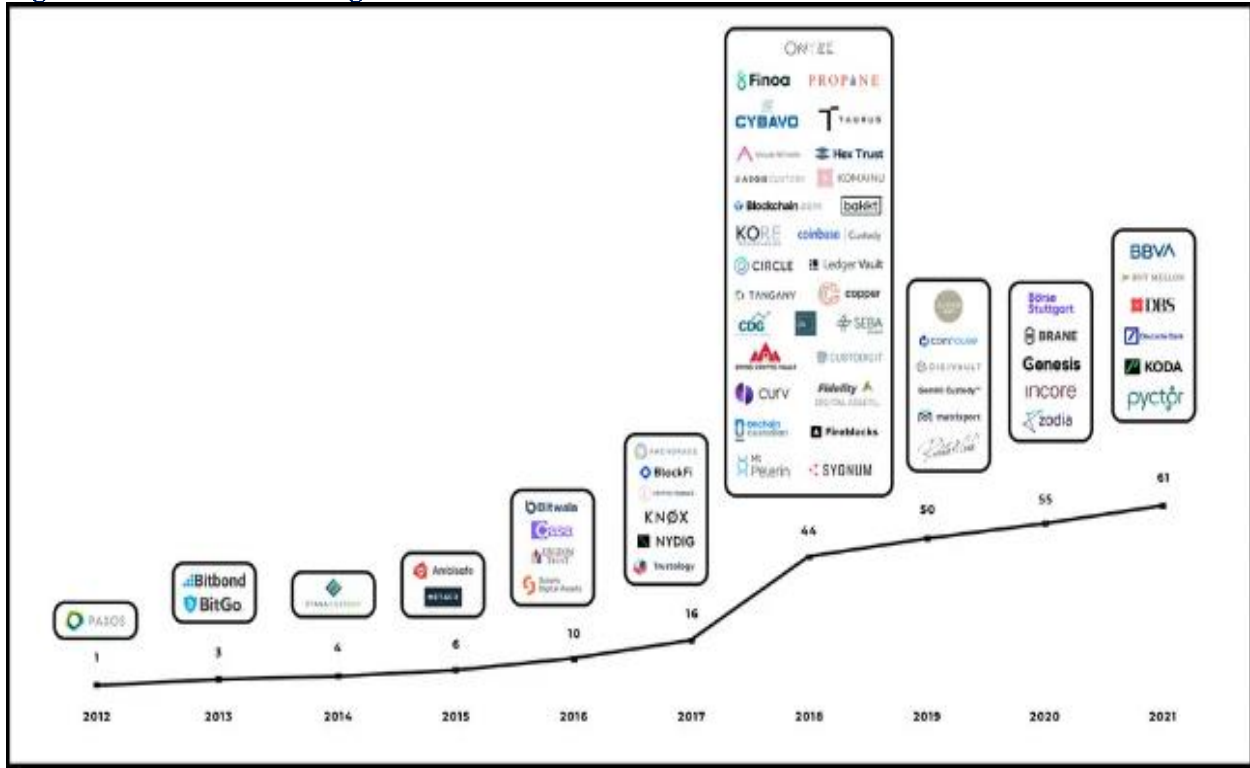
Figure 1: Share of Market Capitalization



Source: Coingecko, Glassnode.com

Private and Confidential: Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited.

Figure 2: Timeline of Digital Custodial Services



Source: Blockdata.tech

Private and Confidential: Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited.

Disclaimer

This communication, including any attachments, is intended only for the use of the addressee and may contain information that is confidential or otherwise protected from disclosure. Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited. If you have received this communication in error, please delete this message, including any attachments, and notify the sender immediately. The information and any disclosures provided herein do not constitute a solicitation or offer to purchase any security or other financial product or investment and is not intended as investment, tax, or legal advice. Unless otherwise noted, all information is estimated, unaudited and may be subject to revision without notice. Past results are not indicative of future results.

Private and Confidential: Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited.

OneRiverDigital

ASSET MANAGEMENT

w: oneriveram.com | e: info@oneriveram.com

2200 Atlantic Street, Stamford CT 06902

NFA ID: 0461647 | FINRA: 167835