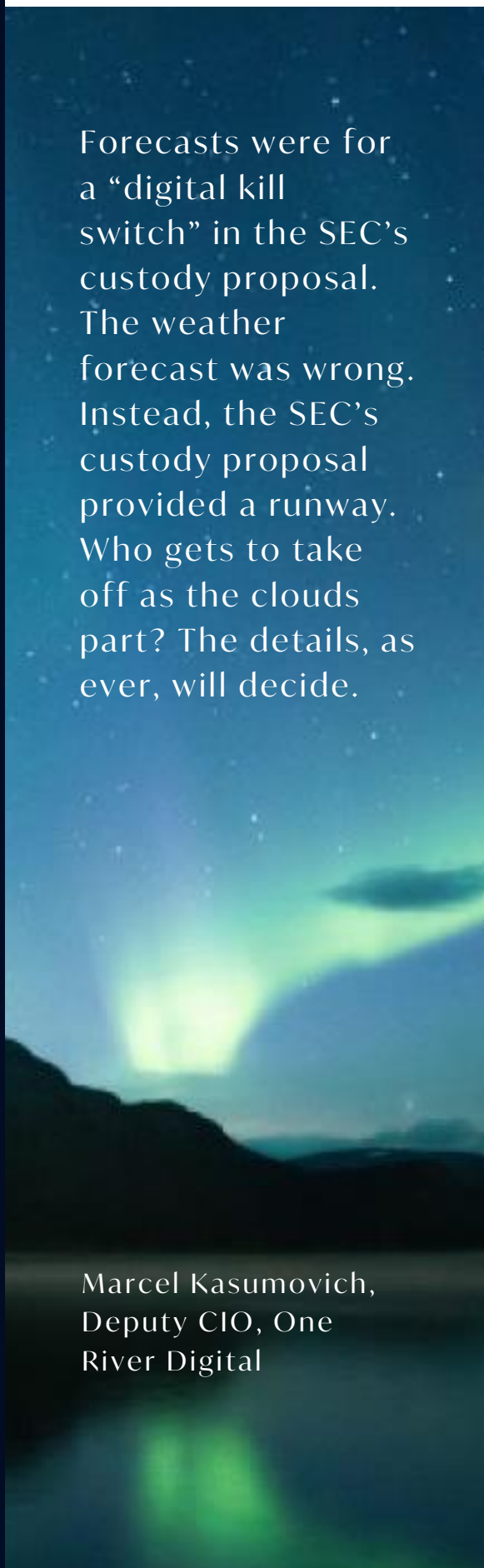
ONERIVER DIGITAL
ASSET MANAGEMENT

market notes: SEC's Leap of Clarity

17 FEBRUARY 2023



Marcel Kasumovich, Deputy CIO, One River Digital

1. "No honest business need fear the SEC." The first Chair of the SEC, Joseph Kennedy, was charged with the task of bringing full disclosures to the public when companies issued securities. Of course, this was after the hands-off policy of the roaring 20s and the 1929 Crash. Kennedy observed "it was prophesied that the securities markets…would dry up within a few months," only to see every major American stock exchange register, thrive, under the SEC.

2. Cryptoassets had their 1929 moment last year, and the post-crash regulatory response is uncertain. The safeguarding of client assets is at the heart of investor protection. And market concern of a severe response was palpable heading into this week's SEC custody proposal. No honest business would argue against the spirit of the proposal: to "expand and enhance the role of qualified custodians…to help ensure that advisers don't use, lose, or abuse investors' assets," as Chair Gensler said.

3. It's not a kill switch. The market feared a shuttering of US activity in digital assets – the SEC eliminating a pathway to being a qualified custodian, the Treasury outlawing self-custody, and the Fed culling banking ramps to digital business. Through enforcement and proposal, clarity is emerging that centers around avoiding a repeat of 2022. The SEC's proposal will remain open to public feedback for 60 days before going live in a year. It's a short and bumpy runway. But there's a route to lift off.

4. Details matter – a lot. "We understand, for instance, that it is decreasingly common for banks acting as custodians to do so in a fiduciary capacity. These changes in the industry have caused us to reconsider the role of a 'qualified custodian'," is an example of a stern assessment of custodians (our emphasis). State laws are key. Segregated customer funds in their name are likely bankruptcy remote. This opens a lane to holding cryptoassets in a "qualified custodian". Advisers can service cryptoassets.

5. But details matter to regulators, too. Investor protection is the natural domain of the SEC. With a broader assessment of assets captured by the proposal – including previously exempt private assets – the issue of being a security or not doesn't matter in the custody proposal. All cryptoassets will apply. But the SEC isn't the regulator for custodians! What if proposed guidelines aren't met? Regulators, including States, will need to work cooperatively. It's not all about the SEC, after all.

6. These are not new issues. Last Spring, the SEC sprung SAB 121 on cryptoasset custodians. It effectively took banks out of the market with onerous capital requirements relative to the custody of traditional assets. It also required new disclosures in the industry to reflect uncertainty around bankruptcy protection. This, too, is at the heart of investor protection. Upon bankruptcy, the goal is to ensure that custodied assets are returned to clients, rather than being the property of the defunct entity.

7. The benefit of living through 1929-like crash is that we now have case precedent. Things to avoid in the future. Like Celsius. On January 4, 2023, the bankruptcy court ruled that a significant portion of customer assets were the property of the debtors' estate – customers were deemed general creditors. Those assets were held in the "earn" program – not segregated. Celsius deployed those assets to generate returns in a discretionary manner, and their contractual terms were explicit. There was no protection.

8. Celsius customer risk is exactly what the SEC is aiming to guard against, reasonably. That's good for the industry. The Commission can also communicate through disclosures of publicly traded companies under their supervision. That's Coinbase. Their latest 10K observes that "we place great importance on safeguarding cryptoassets we custody and keeping them

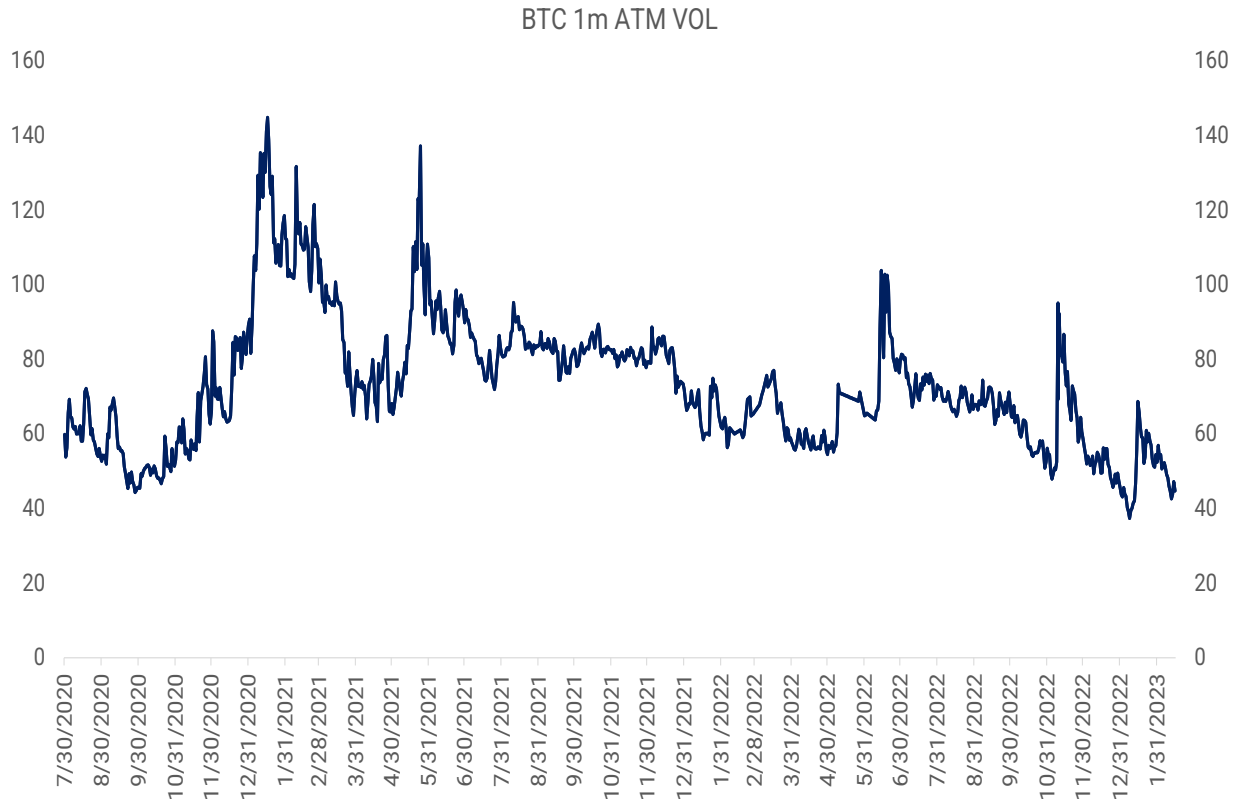
bankruptcy remote…in June 2022 we updated our Retail User Agreement to clarify the applicability of UCC Article 8 to custodied crypto assets."

9. The Uniform Commercial Code – UCC – are the laws governing all US commercial transactions. It's State law. Article 8 is used by the crypto industry to indicate their intended custodial standards are the highest of investment securities. But it's just a bridge until digital assets are fit into UCC – Article 12. That article provides a clear definition to controllable electronic records, and it's passing through State legislatures now. Article 12 is key to bankruptcy –custodial relationships can be clearly defined, and not as general creditors.

10. Make no mistake – there is a sense of urgency in regulatory policy since the crypto crash. This is the historic norm. The SEC's proposed custody rule makes three key strides. First, it reaffirms that all cryptoassets will apply to the rule. Second, it sets the standard that a "qualified custodian" intermediary will need to ensure client assets are remote from bankruptcy beyond any doubt. And third, it advances dialogue with the industry.

11. Clarity is arriving in the same way that the picture of a puzzle becomes visible – piece by piece. It's not just the SEC, or the Treasury, or the Fed. It is a broad integration – State laws play a big role, too. But don't look to regulatory policy to mark a new, positive trend in digital asset markets. That's not the point. Clarity clears a path for the drivers of value – innovation, use cases, and adoption.

Figure 1: Volatility Markets Looking Beyond Regulatory Uncertainty



Source: Block Research.

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.

ONERIVERDIGITAL
ASSET MANAGEMENT

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

2200 Atlantic Street, Suite 310, Stamford CT 06902

NFA ID: 0461647 | FINRA: 167835