



## February 2023 Investor Update

### ProChain in the News

[Bitcoin Above \\$22K 'Remarkable' Sign of Resilience](#); *Coindesk*, Feb 14

[Crypto regulation looms, but bitcoin rallies](#); *MarketWatch*, Feb 16

As you'll see below, most recent developments in cryptocurrency relate to legal and regulatory matters.

We think that is going to be a broad theme for 2023.

In that vein, earlier today, the US Court of Appeals for the DC Circuit heard oral arguments from **Grayscale** and the **SEC** regarding Grayscale's application to the SEC to convert its **Grayscale Bitcoin Trust (GBTC)** into an exchange-traded product/fund (ETP/ETF).

You can listen to the hearing [here](#) (starting at minute 36).

In *ProChain's* opinion, the SEC was VERY challenged in explaining why the SEC has approved an ETP based on Bitcoin futures and has denied a Bitcoin spot ETP. And, the court seemed quite bothered by the SEC's unjustified position.

We don't expect that the SEC is going to give up its fight. HOWEVER, we believe that this may be one instance of the judicial branch beginning to reign-in the SEC's haphazard, arbitrary, capricious, tardy and derelict strategy of regulating the cryptocurrency sector by enforcement. The broken legislative branch is unable to effectively govern and control the SEC, and the current executive branch seems supportive of this SEC's tactics. We don't believe that reigning-in the SEC is the court's purpose; it's simply going to be the result of the SEC having to justify its activity, legally.

Furthermore, we believe that US bankruptcy courts in cases, such as, Celsius, Voyager and FTX, may be forced to decide clearly whether certain cryptocurrencies are "securities", and other primary crypto legal issues, further neutering the SEC.

We are excited to see the next months of development in the courts.

### 1. Adoption

a. *Investment.*

- **Omid Malekan**, a Columbia Business School professor, [argues that stablecoins create global demand for U.S. dollars](#) and solidify the USD as the world's reserve currency.

b. *Currency and Use.*

- **Tether**, the issuer of the largest stablecoin in the market, **USDT**, [released a report that evidences a 4Q22 profit of \\$700 million](#). In addition, as previously intended by Tether, the company has totally eliminated commercial paper from its balance sheet and has continued to remove secured loans from its balance sheet, in favor of shorter-duration, more liquid assets.
- **Bitcoin** has become the new and hot platform for NFTs, leading to an additional use case for Bitcoin; [referred to Ordinals, in short](#).

## 2. Regulation and Legal

- The biggest news in early February was the **SEC's** attack of **Kraken**, the resulting \$30mm fine, and most importantly, the shutting down of Kraken's US staking business.
  - **Staking**, the process of locking tokens, such as ETH, to validate and secure the network and receive rewards/returns, has become a major business line for centralized exchanges looking to diversify their revenue streams away from transaction fees. The exchanges have been promising their staking customers some kind of yield, fixed or variable.
  - The SEC justified its attack as being against Kraken's "unregistered offer & sale of securities thru its staking-as-a-service program." The SEC continued, "whether it's through staking-as-a-service, lending, or other means, crypto intermediaries must provide the proper disclosures & safeguards required by our laws." SEC Chairman **Gary Gensler** even [published a video on the subject](#).
    - SEC Commissioner **Hester Peirce** railed at her Commission, stating "Instead of taking the path of thinking through staking programs and issuing guidance, we again chose to speak through an enforcement action, purporting to 'make clear to the marketplace that staking-as-a-service providers must register and provide full, fair, and truthful disclosure and investor protection.'"
      - "Most concerning, though, is that our solution to a registration violation is to shut down entirely a program that has served people well."
      - ["A paternalistic and lazy regulator settles on a solution like the one in this settlement](#): do not initiate a public process to develop a workable registration process that provides valuable information to investors, just shut it down."
  - **Nexo** has also settled a dispute with the SEC and [agreed to stop its Earn Interest Product for US clients](#). Earn Interest is similar to the yield products offered by Celsius, Gemini and Voyager.
  - The SEC's success in banning staking programs will benefit decentralized alternatives like **Lido** and **RocketPool**, the largest and third largest ETH-based platforms by value.
    - Some believe that the SEC's moves are part of a larger US Presidential initiative of [Operation Choke Point 2.0](#) and [all-out attack on crypto](#).
  - Seemingly, **Coinbase (COIN)** is ready to fight for its staking service. The company's CEO, Brian Armstrong, commented "Coinbase's staking services are not securities. We will happily defend this in court if needed."

- **Stablecoin** issuer, **Paxos**, which is behind **Binance's** BUSD, is being [investigated by New York Department of Financial Services](#) and was [ordered to stop issuing the BUSD](#). Paxos is regulated as a NY Trust Company by the NY Department of Financial Services. Paxos' largest business is issuing stablecoins on behalf of other entities.
  - Pursuant to requirements, all stablecoins issued by Department of Financial Services regulated entities are required to be fully backed 1:1 by cash or cash equivalents. Paxos takes USD and issues BUSD on the Ethereum blockchain. For every \$1 of BUSD issued on Ethereum, Paxos has \$1 of collateral.
  - However, in 2020 and 2021 wrapped-BUSD was created on BNB without 1:1 backing. Stablecoin dollars were fabricated out of thin air. In January, Binance admitted that it did not always have 1:1 backing. \$1 billion of additional wrapped-BUSD on BNB had been minted without the accompanying BUSD collateral on Ethereum. Binance backfilled the missing collateral subsequent to the shortfalls.
  - It's no surprise that **Binance** is [considering pulling back from the US](#). [US regulators have objected to Binance US's \\$1B purchase of Voyager](#) from its bankruptcy, which Binance after FTX's purchase of Voyager collapsed due to FTX's bankruptcy.
  - **ProChain**- This action seems to be a Binance-centric issue, as opposed to a broad stablecoin issue
- Separately (but maybe in coordination with the NYDFS), the **SEC** announced an investigation of **Paxos** over whether BUSD is a security. This could be [a BIGGER deal](#).
  - The stablecoin product is currently critical to the crypto ecosystem; it allows for quick and smooth purchase of assets. Further, the stablecoin business is profitable. Companies, such as Paxos, have found a steady source of income by issuing stablecoins and investing users' cash deposits in short-term U.S. Treasuries, which have yielded more as the Federal Reserve raised interest rates.
  - If the SEC is going to seriously contend that stablecoins, which do not necessarily represent an investment in anything, other than the US dollar, are "securities", [then we have to assume that all crypto assets \(maybe inclusive of Bitcoin\) are ripe for attack by the SEC](#).
  - The short-term fallout favors **Tether** (based in Hong Kong).
  - In reaction to the SEC investigation, **Paxos** has announced that it is ["prepared to vigorously litigate" to protect its stablecoin business](#).
- Pursuant to the third haymaker to crypto in recent weeks, on Feb 15, the SEC announced a proposal to amend existing rules for **Registered Investment Advisors (RIAs)**.
  - The SEC wants RIAs to hold and transact in **any** client asset (including crypto and artwork) with a **Qualified Custodian**.
    - Most crypto exchanges are not Qualified Custodians. Therefore, most investors, from institutional to individual, will be cutoff from being able to hold cryptoassets on most centralized exchanges, which will drive activity to decentralized exchanges and self-custody solutions.
- **ProChain summary**
  - US regulators are pressing on multiple fronts (staking, stablecoins and RIAs/QCs) to make sure that, to the extent humans are offering services to crypto owners, those service providers have proper disclosure, licensing and reporting, and commensurate capitalization and risk management.
  - Most blockchains (other than Bitcoin) run on **Proof of Stake (PoS)**, such as Ethereum, Cardano, Solana, and others. The recent staking settlement between the SEC and Kraken **puts staking, and PoS, at risk for the future**.

- **Stablecoins** are core infrastructure for the cryptocurrency market. Nearly every crypto pair is tied to a stablecoin for ease of transactions. If stablecoins such as USDC or USDT come under heavy scrutiny, or are forced to register as securities, **it could have seismic effects across the entire cryptocurrency sector.**
- If crypto service providers will need to become **Qualified Custodians** to transact with US customers, the barrier to entry and the cost to compete in the crypto industry will rise significantly.
- On the one hand, these regulatory activities will make crypto enterprises think twice before establishing a presence in the US, as opposed to almost anywhere else in the world. On the other hand, these sentiments are knee-jerk reactions in the wake of the major frauds, debacles and bankruptcies of the past 6 months and the product of a narrow-minded administration, which is largely made up of elected officials that come up for re-election sooner than crypto can be quashed.
- For some, [this is the moment for TradFi to swoop in and coopt crypto.](#)
- Furthermore, it is possible that courts (bankruptcy courts and other federal courts) can steal the mantle from the SEC.
  - In the crypto bankruptcy cases currently pending and proceeding, judges are immediately being required to decide whether crypto assets are property or securities.
  - In the case of Grayscale's petition for a Bitcoin ETF, the DC Circuit Court of Appeals is going to rule on the SEC's denial of the ETF application in the face of its own approval of a Bitcoin futures ETF, which could include some important broader commentary about crypto assets and their legal classification.
- **Dubai** has made it [anonymity-enhancing cryptocurrencies, such as Monero and ZCash, illegal.](#)

### 3. Public Companies

- An important component to the world of crypto in respect of buying, holding, and trading, **Silvergate Bank (SI)**, has experienced a run on its deposits.
  - As far as we currently know, there has been no impropriety at Silvergate and its shrinking (and possible demise) is coming from [a rush of withdrawals, especially from large depositors, such as, Coinbase, Galaxy Digital and Paxos.](#)
  - Recently, [Silvergate shuttered its hallmark SEN \(Silvergate Exchange Network\) platform,](#) which enabled users to transfer crypto and fiat currency 24/7.
- Amid the recent attacks by US regulators on staking and stablecoins, **PayPal (PYPL)** [has paused work on its branded stablecoin,](#) which was supposed to be issued by **Paxos.**



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