FCAM
Decentralised Digital Investing

Monthly Commentary

FEBRUARY 2023 PERFORMANCE

TOTAL NET RETURN

PERIOD	FUND RETURN
1 Month	-0.30%*
Life to date	-21.91%*

*Post management, performance and entry fees. Past performance is not indicative of future performance.

The Fort Stable Fund generated a return of -0.30% for the month of February 2023. ETH ended 4.3% higher at $1634 after being in a relatively volatile 16% range between a low of $1460 and a high of $1725. The main reason for the intra month volatility was the exceptional amount of regulatory news, which was released, and we cover in this note. It was difficult to interpret the news in real time and as such we elected to maintain our positioning for most of the month. Unfortunately, despite ETH finishing slightly higher by the end of the month, the time decay and decline in implied volatility on our options positions resulted in the small loss for the month.

Given the relatively constructive price action in the face of the regulatory and macro news, we are of the view that a lot of the bad news for crypto is now in the price. Towards the end of the month, we increased our ETH exposure to around 13% long.

Over February the macro narrative shifted very quickly in the U.S., from "inflation has peaked" to one where the economy was likely growing at such a rate that the authorities were going to need to maintain a restrictive stance for longer. We had a Jobs number that indicated the US economy added 300,000 jobs, we had an earnings season that showed very little stress to bottom lines and anecdotal indications that some prices in the economy remained elevated. This saw a reversal of sentiment in the risk seeking behaviour of January as the market priced out Interest Rate cuts and the USD rallied. Digital Assets however performed reasonably well given this headwind and the regulatory actions largely trading in a wide range.

In the first part of this month's note we will deal with the regulatory situation, and try and put some context around what's happening, and the second part we will focus on efforts to utilise blockchain technology to improve business processes.

First the regulatory backdrop:

We have seen in the US, predominantly, a variety of actions from regulators that are a response to the wide range of failures last year, with the crescendo being the FTX bankruptcy. Regulators have an extremely challenging job. The challenges they face are multi-faceted

- They are inherently under resourced, which sees them being forced to be reactive versus proactive.
- They are often enforcing laws that are ill suited to the task at hand so run the risk of being challenged by better resourced adversaries in industry.
- They can be fighting with other regulatory bodies for resources so can overreach their mandate.

This set up sees them enforcing rules in response to problems as opposed to regulating in a manner that encourages innovation with appropriate safeguards in place.

The SEC was the most active regulator and moved on organizations this last month that are regulated under their purview, namely Kraken and Paxos. Without an updated set of rules for digital assets the SEC are compelled to fine, prosecute and punish participants based on existing laws. In this case the SEC relied on "The Howey test" which is a depression era law that came into existence establishing the rules for what is defined as a security. In an ideal world the process of enforcement of digital assets under this law is

challenged and ratified and then sets a precedent that for the SEC gives them power of enforcement.

This process will continue to play out until such a time that we have full legislation, The SEC will continue to try and control the narrative and represent the ad hoc actions as progress and the industry will respond and draw lines challenging rulings where they can. In due course we will get a set of laws from congress and lawmakers that will give those developing and building a level of confidence. Given the US's role in the financial system their actions will have ripple effects across Western nations with places such as Australia likely to follow a similar path. Lawmakers are aware that Digital assets are by nature global and can be decentralised, there is a risk that activities may move away from the US or an environment that isn't constructive, so they will attempt to tread a fine line between protecting investors while embracing innovation.

Moving on to the actions:

1. The Banks

One of the features of the US banking system is that charter banks have insurance against loss of depositor assets, this insurance comes with oversight by the FDIC. Banks in the US operate under a Federal or State charter, ie they are monitored by differing bodies at a national or local level, there are also uninsured State charter banks. There has been a push by a few states in the US to embrace blockchain technology, notably Wyoming and Kansas, and there has been a push in those states to create banks capable of leveraging the technology and supporting the industry. These have largely been uninsured state charter banks and are smaller banks generally.

Late January the Kansas City Fed branch denied a bank called "Custodia" their application for a master account, which would have given it the ability to use wholesale payment services, and to hold reserves with the Fed directly. This is a relatively benign activity

Also on that same day The Federal regulators interceded issuing a policy statement "The Crypto Policy restricts the activities of uninsured state member banks to be the same as insured state banks. This will have the practical effect of deterring uninsured state banks from seeking membership in the Federal Reserve System as a way to engage in novel activities, such as those involving crypto-assets, and obtain access to Federal Reserve services (e.g., payments through FedWire). It also continues to foreclose a number of crypto-asset activities for all state member banks." These two actions have restricted progress and access to these banks of the existing financial system, largely it would seem to reduce systemic risk being transferred to the traditional Finance system.

There were actions also against banks with existing large digital asset holdings. An investigation into Silvergate's role in the FTX fiasco and Signature bank being ordered to not facilitate retail flows into Binance outside of the US. Silvergate has seen large outflows, however met all obligations as the space contracted and investors moved their money away from the bank. Equally Signature has complied with the request.

There have also been actions in Europe to risk weight digital assets that would make them onerous for banks to hold on their balance sheet. Again this is largely symbolic as banks are unlikely to hold digital assets at this current stage and it was flagged as being in place until there was greater regulatory clarity.

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These requests made of banks are largely an attempt to ringfence banks and increase the difficulty of retail flows to gain access to crypto. On one hand you can understand the regulators with limited suitable laws to rely on attempting to reduce the points of entry for unsophisticated investors but on the other it's the antithesis of one of the core tenets of the Digital Asset space which is a more inclusive financial system with free access and limited rent seekers. Looking objectively at what's going on here, it's not a wholesale ban or blockade of access rather its ensuring that access is restricted to sophisticated investors while the regulators wait for the laws to catch up.

2. The Custodians:

SEC has proposed rules that would force US investment advisers to secure all the client assets that they manage including digital assets with what they call qualified custodians. SEC chair Gary Gensler issued a statement with the announcement. "Though some crypto trading and lending platforms may claim to custody investors' crypto, that does not mean they are qualified custodians,". "[This] proposal, in covering all asset classes, would cover all crypto assets — including those that currently are covered as funds and securities and those that are not funds or securities."

The proposal, while not policy yet, would force investment advisers to draw up agreements with qualified custodians to ensure a client's assets were segregated and protected in case the custodian collapsed. Qualified custodians are heavily regulated financial groups such as banks, broker-dealers and trust companies. Currently in the digital asset space there is one Federally regulated custody business in Anchorage, there are numerous others regulated at a state level.

This will be met with mixed feelings by people in the industry, the option of self-custody is a feature, not a bug, of the holding of the Digital Asset. The idea that rent seekers have been inserted mandatorily back into the chain again would be resisted as often these participants are likely to slow the adoption of the technology as they are invested in the legacy industry.

On the other hand the industry needs capital and acceptance to be fully developed. For a large cohort of investors not having a path to investing that includes utilizing a known, trusted custodian or even a well-defined set of rules has been an impediment to participation. Therefore clarification will expand the total addressable market and speed adoption and investment in the space.

As indicated this isn't a law yet, its merely a proposal and it's a wide proposal covering everything from art to digital assets but unlike the other regulation by enforcement this proposal feels better thought out. The largest issues will likely be the cost of custody as it's currently expensive and the mandatory nature of the ruling, i.e. no capacity to opt out and self-custody assets. Given the issues that we have dealt with in the broken promises of FTX and their attestation that assets were held separately the response of the regulator is at least understood.

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3. The Exchanges:

There was significant action taken by the SEC on US based crypto currency exchanges.. In summary the staking service offered by centralized exchange Kraken was deemed to be offering a security, Kraken have closed the offering and paid a $30m fine. They have admitted no liability and there is no precedent set, they deemed it expeditious to pay the fine and concentrate on their core business. So what exactly did they do wrong? The staking service that Kraken offered was deemed the offering of a security, as stipulated by the Howey test – "where there is an investment in a common enterprise with profits earned exclusively through the work of others." For Kraken this business was small, so perhaps it was expeditious for them to settle rather that contest it. Also the way that it was structured in that they took custody of your asset and distributed the investor a return, perhaps moving it closer to the definition.For someone like Coinbase on the other hand it's a large business at around 11% of their revenue. Coinbase has cash balances in excess of $5bn and they will likely contest any action against them if forthcoming. The set-up they have for staking also differs from Kraken such that they facilitate the staking for a fee but the individual holds their own assets, this will likely see them argue its not an "investment of common enterprise". Other services such as LIDO and ROCKETPOOL remain untouched.

Staking and proof of work blockchains are not the issue so far, rather it was the way that Kraken was offering the product. The concept of staking is key for the delivery of decentralised blockchain. These services make it easy for retail investors to participate and secure the network, these enforcement actions will become a sort of precedent to try set rules by which they can be offered to retail through any centralised provider.

Another action by the SEC was against Paxos who have been issuing the BUSD (Binance) stable coin, Paxos are regulated by SEC. This feels like a regulatory pushback against Binance who certainly have a Byzantine corporate structure. Binance elected to outsource the creation of their stable coin to Paxos and have them manage the reserves backing it. These audited assets as managed by Paxos sit inside the Traditional finance system. This was instead of keeping the assets backing any stable coin outside the US with no oversight and unverified. Paxos have indicated that they will challenge this ruling legally. The irony of this action is that investors have been forced to move to UST (Tether) that is outside the purview of US regulators and has had issues with full asset backing which is why we have avoided using the product.

In summary

Most of the narrative over the month was that the industry, at the professional end of the spectrum, generally has no issue abiding by rules that protect investors. What they do have issues with is "Regulation by enforcement". Regulation by enforcement is the only path currently that the regulators are left with, laws haven't kept up with a changing landscape. The events of the last month highlight the desperate need for U.S. and indeed global regulatory clarity around digital assets. .

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The SEC's actions against staking may or may not be technically in line with the Howey Test precedent. However, what's apparent is that Depression-era laws now seem to be wholly inadequate for the current times. The current SEC commissioner Hester Pierce is clearly at odds with SEC chair – her dissent is here and summed up in this quote "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."

For now the regulatory actions seem designed to slow down adoption at the retail end of the spectrum, which is understandable from their perspective. Professional investors will find ways to access products and projects will continue to evolve. The silver lining in all of this is that with a more uncertain outlook regarding centralised offerings and the status of counterparties there is renewed focus on developing a more robust decentralised infrastructure and trading platforms.

Time to look at the Future

The promise of blockchain technology is that it removes barriers and drives efficiency. While most of the obvious development has been in the finance sphere where we have created, what you would effectively call an alternate financial system, there are many other projects looking to streamline physical business processes. One of the leaders in this push has been the Accounting and consultancy firm EY and the head of their Blockchain business Paul Brody. They have been investing in and developing infrastructure for over 6 years that expect that their customer base will adopt in due course. Lets dig in.

Ernst & Young and their Involvement in Blockchain

EY, also known as Ernst & Young, is a multinational professional services firm that provides assurance, tax, consulting, and advisory services to clients worldwide. With a global network of over 300,000 employees, EY has established itself as one of the "Big Four" accounting firms along with Deloitte, KPMG, and PwC. However, in recent years, EY has taken on a new challenge - blockchain auditing.

EY's Involvement in Blockchain Auditing: As a professional services firm, EY has a long history of providing auditing services to clients across various industries. With the rise of blockchain technology, EY recognized the need for transparent and secure auditing of blockchain-based transactions. In response, EY developed its blockchain auditing service, which it calls EY Blockchain Analyzer. EY Blockchain Analyzer is a suite of blockchain analytics tools that enable auditors to search, track, and analyse blockchain transactions. By using advanced data analytics, EY can provide its clients with real-time insights into their blockchain-based transactions, including the source and destination of funds, the amount of funds transferred, and the date and time of the transaction. This level of transparency and accountability is essential in today's digital world, where fraudulent activities and cyberattacks are rampant.

Private versus Public Blockchains. What's the difference?

Paul Brody, EY's Global Blockchain Leader, describes private and public blockchains as two different types of blockchain networks with distinct characteristics and use cases.

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Private blockchains, also known as permissioned blockchains, are controlled by a single organization or consortium of organizations. Access to the blockchain network is restricted to a pre-defined group of participants who are granted permission to read, write and validate transactions. Private blockchains typically have higher transaction throughput, faster confirmation times, and lower fees compared to public blockchains. Private blockchains are often used by enterprises for internal operations, such as supply chain management or payment processing.

Public blockchains, on the other hand, are open and decentralized networks that allow anyone to participate and verify transactions. Public blockchains have no central authority, and transactions are validated by a network of nodes through a consensus mechanism. Public blockchains are often used for cryptocurrency transactions, as well as for decentralized applications (dApps) that require the ability to operate in a trustless environment. Public blockchains have lower transaction throughput, longer confirmation times, and higher fees compared to private blockchains.

According to Brody, private and public blockchains serve different purposes and are suited to different use cases. Private blockchains are ideal for use cases where privacy, security, and transaction throughput are important, and where a defined group of participants needs to interact in a trusted and efficient manner. Public blockchains, on the other hand, are ideal for use cases where transparency, decentralization, and censorship-resistance are important, and where anyone can participate in a trustless environment.

Overall, Brody emphasizes that both private and public blockchains have their strengths and weaknesses and that choosing the right type of blockchain for a particular use case depends on the specific requirements and goals of the application.

And what is an Enterprise Blockchain?

Again, EY's Brody defines enterprise blockchain as the use of blockchain technology to transform business processes in large organizations. According to Brody, enterprise blockchain goes beyond the creation of cryptocurrency or tokenization of assets and involves the development of solutions that can be used to solve complex business problems in a variety of industries.

Brody emphasizes that enterprise blockchain solutions are focused on creating shared, decentralized ledgers that can be used to verify transactions, track assets, and automate business processes. These solutions are designed to provide increased transparency, security, and efficiency while reducing costs and risks associated with traditional business processes.

In addition to creating shared ledgers, Brody also highlights the importance of building interoperable blockchain solutions. This involves creating systems that can communicate with each other, as well as with existing enterprise systems and applications, to ensure seamless integration and enable new use cases.

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Supply Chains on a Public Blockchain

While the initial opportunity was a blockchain auditing service, EY identified and is working on developing software that will enable enterprises to put their supply chains on a public blockchain. The goal of this project is to increase transparency and efficiency in supply chains while reducing costs and improving customer trust.

Three Key Challenges for Enterprises to adopt a public blockchain.

Privacy

One of the key challenges of implementing a public blockchain solution for supply chains is the need for privacy. Enterprises must protect their sensitive data while still ensuring that the blockchain is transparent and auditable. While public blockchains offer a high degree of transparency, they also expose all transaction data to the public, which can be a problem for businesses that need to keep certain transactions confidential.

Scalability

Public blockchains, such as the Bitcoin and Ethereum networks, have struggled to keep up with the increasing demand for their services, which has led to high fees and slow transaction times.

Security

Another challenge in using public blockchains is that they are vulnerable to attacks from bad actors who may try to exploit vulnerabilities in the system.

EY has been actively working on developing privacy-enhancing technologies for public blockchains, including their work on Matic Network, a layer-2 scaling solution for Ethereum. Matic Network is designed to provide faster and cheaper transactions on the Ethereum network by using sidechains, which can process transactions in parallel with the main Ethereum chain.

One of the key features of Matic Network is its support for privacy-enhancing technologies, such as zero-knowledge proofs (ZKPs). ZKPs are a type of cryptographic proof that allow for the verification of information without revealing the information itself. This can be used to protect sensitive data, such as transaction details or personal information, while still allowing for the verification of the transaction.

EY has been working on integrating ZKPs into Matic Network to enable privacy-enhanced transactions on the platform. In June 2021, EY announced the launch of Nightfall 3, a suite of privacy tools that can be used with Matic Network and other public blockchains. Nightfall 3 includes support for ZKPs, as well as other privacy-enhancing technologies such as ring signatures and stealth addresses.

EY's Nightfall, a five-years-in-the-making system allowing businesses to shield the content of transactions on the public Ethereum blockchain, has entered its final phase of production readiness for deployment using the Polygon network.

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The latest updates to Nightfall have made its code fully decentralized, meaning it can run anywhere with no single entity being in charge, as well as adding industry standard X.509 identification certificates. These final updates herald the product going live in May of this year, said EY Global Blockchain Leader Paul Brody

"It's one thing to show that the math works, it's another thing to have a security audited, tested out, hardened system," Brody said in an interview. "We currently have a beta client for the supply chain work that is ongoing now, and we expect to show the first production ready product that uses this network layer at our Global Summit in May."

The goal for EY and Nightfall, which teamed up with scaling specialist Polygon in September 2022, has always been to harness the power of the public Ethereum network for big business. In order to make Ethereum palatable from a data privacy standpoint, Nightfall uses a math-heavy secret sharing technology called zero-knowledge proofs that can hide the content of transactions appearing on the blockchain.

These days, zero-knowledge (ZK) tools have become a popular way to help scale up Ethereum by summarizing transactions using mathematical proofs and enabling data to be moved off chain – known as "roll-ups," in blockchain parlance.

Nightfall takes advantage of certain efficiency trade-offs, creating a "zero-knowledge optimistic rollup." It's an approach that leverages ZK tech for its privacy benefits, while avoiding an overbearing computational load, achieved by allowing batches of transactions to process quickly and be checked afterwards.This approach is a better fit for certain enterprise use cases, versus things like crypto trading or decentralized finance (DeFi), said EY's Brody. "The optimistic part allows us to have a very low cost for transactions," he said. "Enterprises aren't really doing trading. Most of the time, what they're doing is moving 100,000 widgets in inventory and the transaction costs have to be driven as low as possible."

As far as the use of identification certificates goes, Brody said it's not the same as imposing know-your-customer (KYC) on an open system. "We convened with a bunch of banks and other industrial companies last year and it turns out almost nobody can agree on KYC and what it should look like," Brody said. "So we decided we can't go that far. But we can make every company responsible for whom they transact with, and make it fundamentally unattractive for bad actors to use our ecosystem." Details here

Interested readers can read more about X.509 identification certificates here:

The main point is that enterprises care about privacy of transactions. They don't care about anonymity as many are public corporations, so KYC isn't critical.

Nightfall 3 is an open-source software solution designed to enhance the privacy of transactions on the Ethereum blockchain for enterprises. It is the third iteration of the Nightfall project and builds on the previous versions' features to provide a more efficient and privacy-preserving solution

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Nightfall 3 uses a combination of zero-knowledge proofs (ZKPs) and shielded transactions to enable private transfers of Ethereum-based assets. ZKPs allow users to prove the validity of a transaction without revealing any of the transaction's details. Shielded transactions, on the other hand, hide the sender, receiver, and transaction amount from the public blockchain, while still allowing for the transaction to be verified.

One of the main advantages of Nightfall 3 is that it allows for private transactions without the need for a centralized authority to oversee the process. This means that enterprises can maintain control over their data and assets while still ensuring the privacy of their transactions.

In addition to privacy, Nightfall 3 also provides improved scalability and efficiency compared to previous versions. It achieves this by using a new cryptographic technique called recursive proof composition, which allows for the batching of multiple transactions into a single proof.

The use of Nightfall 3 could have significant benefits for enterprises that need to conduct private transactions on the Ethereum blockchain. It could be particularly useful in industries such as finance, supply chain, and healthcare, where privacy is critical. The enhanced privacy features of Nightfall 3 could help to reduce the risk of sensitive data being exposed, while also improving the efficiency of transactions and reducing transaction costs.

Overall, EY's Nightfall 3 represents a significant step forward in the development of privacy-preserving solutions for the Ethereum blockchain. It could help to increase the adoption of blockchain technology by enterprises that require secure and private transactions, and further drive the growth and development of the Ethereum ecosystem.

Non Fungible Tokens (NFTs) – Commercial Use Case for enterprises

One area where Paul Brody has suggested that enterprises could use NFTs in their supply chain is to track ownership and provenance of physical goods. For example, an NFT could be issued for a specific product at the point of production and then follow it through the supply chain, allowing for verification of authenticity and ownership at every step. This could be particularly useful in the luxury goods industry, where counterfeiting is a significant issue.

Another potential use case for NFTs in supply chain management is around tracking and verifying sustainability and ethical practices. For instance, an NFT could be issued for a batch of products that were produced using sustainable materials or labour practices, allowing consumers to verify that the product meets their ethical standards. This could be especially important in industries such as fashion, where there has been increased pressure on brands to ensure their supply chains are transparent and sustainable.

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How big could the Enterprise Market be for the Ethereum blockchain?

Just taking the example of the automotive industry, Paul Brody has previously estimated that the automotive industry could generate as many as 3 billion transactions per day if it were brought onto the Ethereum blockchain. This estimate is based on the various stages of the automotive supply chain, including the production, distribution, and maintenance of vehicles, as well as the financial transactions associated with these processes.

According to Brody, blockchain technology can enable more efficient and secure data sharing across the various stakeholders in the automotive supply chain, including manufacturers, suppliers, dealerships, and consumers. By using a blockchain-based system, stakeholders can potentially streamline and automate certain processes, such as inventory management and payment processing, reducing costs and improving efficiency.

The potential of so many transactions being posted to a blockchain highlights how critical it is to make transactions costs as low as possible if Enterprises are going to adopt a public blockchain such as Ethereum.

According to Brody, after 6 ears of grinding away with a staff of mathematicians and cryptographers, the current version of Nightfall (Nightfall 3) is up to 1,000 times more efficient than the original version.

This improved efficiency and scalability are critical for enterprises and other organizations that need to process large volumes of transactions quickly and securely. By enabling private, efficient, and scalable transactions on public blockchains like Ethereum, Nightfall 3 is helping to drive the adoption of blockchain technology by a wide range of industries and use cases.

How soon does EY expect to see broad based Enterprise Adoption?

Paul Brody has compared the enterprise adoption of public blockchains to the enterprise adoption of cloud computing, noting that both technologies share some key similarities. In both cases, there was initially a lot of scepticism and reluctance to adopt the new technology, with concerns around security, scalability, and other issues. However, over time, these concerns were addressed, and the benefits of the technology became increasingly clear.

Brody has argued that public blockchains have reached a similar point in their development, with many of the initial concerns around security, scalability, and other issues now being addressed through innovations like Nightfall 3 and other advances in the blockchain space. As these issues are addressed, more and more enterprises are beginning to see the potential benefits of public blockchains for a wide range of use cases, from supply chain management to financial services to digital identity.

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In addition, Brody has emphasized the importance of collaboration and interoperability in driving the adoption of public blockchains by enterprises. Just as cloud computing became more attractive to enterprises as more and more applications and services became available on cloud platforms, public blockchains will become more attractive as more and more applications and services become available on blockchain platforms. This will require collaboration and interoperability across different blockchain platforms and ecosystems, something that Brody and others in the blockchain space are actively working to address.

Overall, Brody sees a lot of parallels between the enterprise adoption of public blockchains and the enterprise adoption of cloud computing and believes that we are now at a critical inflection point in the development of public blockchains, with enormous potential for innovation and transformation across industries.

What we really wanted to highlight this month is that there a lot of headlines of late in the digital asset space that are overly and undeniably negative. The purpose of digging deep on the EY initiative was to highlight that large traditional firms are investing precious time and resources into projects that leverage the technology. They are embracing the open source ethos of the space and solving the problems that are slowing adoption. While Digital Assets have been a destination for a lot of the excess leverage that has been available in markets for a number of years and the withdrawal has been painful there is a great deal of activity that is focussed on real world needs. Some of which will transform economies, businesses and cultures. The timeline with any change is always uncertain but there are few certainties, humanity will continue to innovate and look for efficiencies and technology will continue to be a large part of the transition. There is an inordinate amount of time, energy, money and intellectual horsepower moving into the space that gives us confidence that from it there is the kernel of business revolution.

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