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Bitcoin goes to Wall Street

The price of the No. 1 cryptocurrency flirted with $50,000 on Sunday morning, Valentine's Day, but it isn't all hearts and flowers for Satoshi Nakamoto's invisible brainchild. News that Bank of New York Mellon Corp. is planning to embrace the former gangster money might prove to be the kind of tribulation that bitcoin can't put behind it.

The future of the crypto sensation is the topic at hand. As to price in the short run, we are—besides gobsmacked—agnostic. We rule out nothing, not even $400,000-plus, the target that some super-fans have stuck to the wall. We have more conviction about the long run.

There will be a crash, as bitcoin is a bubble.

There will be an associated clearing and margin crisis much costlier than GameStop Corp.'s.

No central bank will, or could, rush to the digital rescue, as bitcoins are unprintable.

Stripped of its monetary pretensions, bitcoin will revert to its legacy role as a crypto version of a Western Union international wire transfer.

To analyze anything, you must first define it. Thus, "bitcoin," says Wikipedia, the digital last word,

> is a decentralized currency, without a central bank or single administrator, that can be sent from user to user on the peer-to-peer bitcoin network without the need for intermediaries. Transactions are verified by network nodes through cryptography and recorded in a public distributed ledger called a blockchain.

Strip away the technical jargon, and you're left with a digital bearer bond. A bearer bond is an unregistered physical security that belongs to whomever happens to possess it. Not for nothing are such instruments known as "divorce bonds." And not for nothing did the Tax Equity and Fiscal Responsibility Act of 1982 effectively outlaw them. As useful as they were in confounding an ex-spouse, they were just as helpful in tricking the tax man.

The genius of Nakamoto shines through in many ways, not least in the design feature that stipulates that the supply of bitcoin can never exceed 21 million units. It's this fixedness that imbues the floating hoard of tokens—some 18.6 million at last report—with value. To make more, you put walls of computers to work solving math problems that, except in the cause of money-making, would be pointless. (That such energy-intensive "mining" makes gold mining look green is, to the bitcoin faithful, irrelevant.)

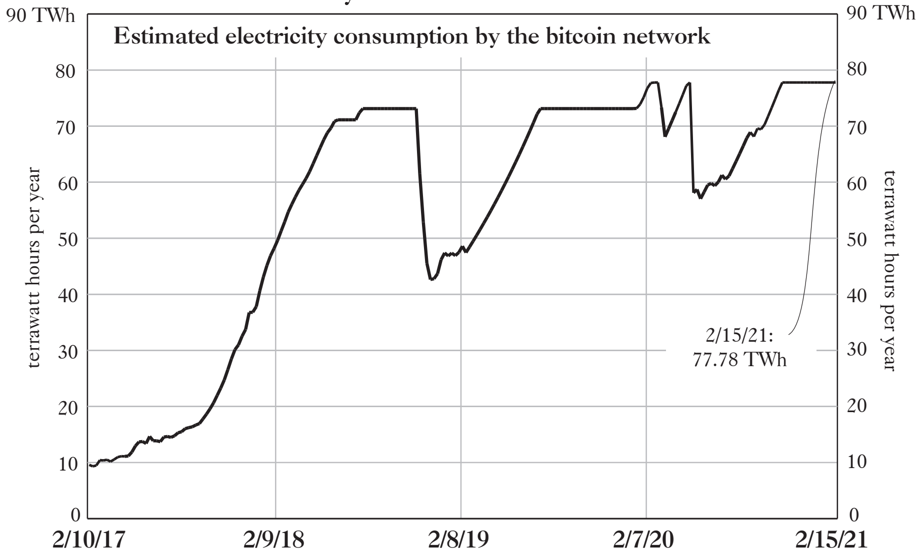
"Hey, everybody, guess which digital ducat just kissed fifty-grand?"

Nakamoto endowed his creation with the properties of anonymity, autonomy and decentralization, so that bitcoin could flourish outside the established fractional-reserve and inflation-prone financial system.

The bitcoin system would require no custodians, collateral agents, transfer agents, banks or central banks. It would clear and settle promptly. It would realize the libertarian dream of a private currency. And like the youthful rebel it was, it would keep no conventional office hours but trade every minute of every day in every time zone. "#Bitcoin," Michael Saylor, co-founder of MicroStrategy and a bitcoin billionaire, has rhapsodized, "is a swarm of cyber hornets serving the goddess of wisdom, feeding on the fire of truth, exponentially growing ever smarter, faster and stronger behind a wall of encrypted energy." On Tuesday, Saylor & Co. disclosed plans to issue $600 million's worth of convertible senior notes, with proceeds earmarked for the purchase of bitcoin, or, as the news site CoinDesk.com put it, "yet more bitcoin."

However that may be, the cyber thing has the essential character of a divorce bond. Lose the private key—your own personal numbered Swiss bank account—and there's no reclaiming it in law or with the help of a friendly voice at the end of a 1-800 telephone number. What remains to be seen is how bitcoin can straddle Wall Street and the Wild West (its legacy turf) without becoming what Nakamoto seems never to have intended it should be.

Green—as in money



source: Digiconomist.net

In early days, a buyer and seller of cocaine, surface-to-air missiles, etc. would find each other on the web. The seller would direct the buyer to deposit the appropriate number of bitcoins in his numbered account on the distributed ledger. Signing them over, the buyer would conclude the tax-free transaction. There was no Wall Street about it: no reporting, no leverage, no anti-money-laundering (indeed, the whole point was money-laundering). The blockchain displays no prices, matches no orders, performs no custodial services and facilitates no leverage. It's a ledger.

The soaring bitcoin price, never mind the growing cult around that price, provides the impetus for the institutionalization of the Nakamoto token as well as a formidable barrier against that transformation. You hear it claimed that the bigger the BTC market cap, the safer one's crypto investment becomes, since a flyaway price signals the currency's coming of age. The opposite is closer to the truth.

The higher the price, the greater the incentive both of speculators to apply leverage (thereby weakening the structure of the market ahead of its coming collapse) and of hackers, including state actors, to steal. Bulls don't need to be reminded about the massive 2014 heist at Mt. Gox, then the world's largest bitcoin repository. They acknowledge that there are security risks but contend that anti-hacking defenses are in place—you can read in Wikipedia how Coinbase thwarted a 2019 attack without the loss of a single token.

Actually, few laymen will be able to make heads or tails of the details of the Coinbase security narrative, including a story about a Firefox vulnerability that allowed "the attacker to escape the browser sandbox and execute code on the host computer."

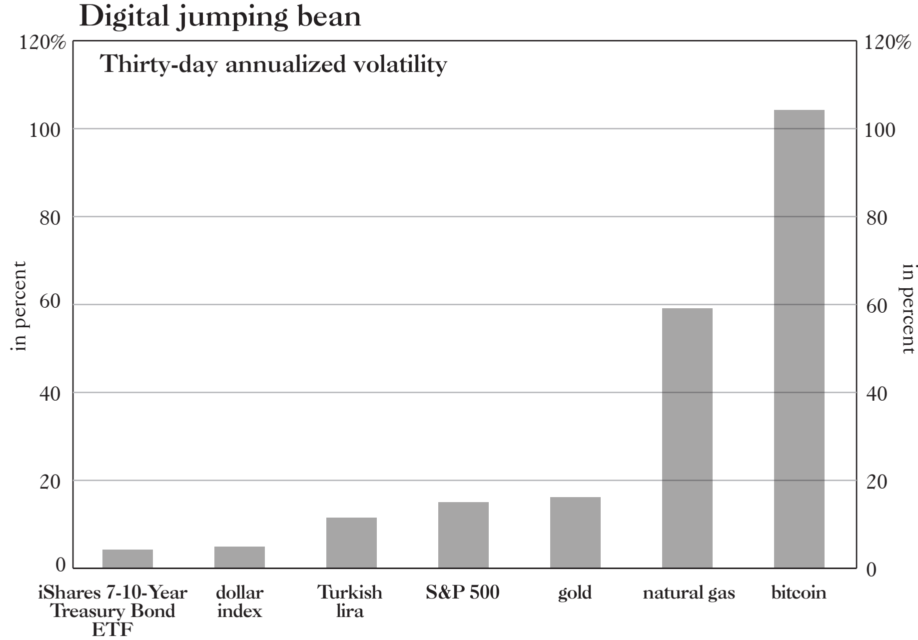
Which is not to say that there's no conclusion to be drawn. The lesson is—to borrow the boilerplate language in the risk section of a standard securities prospectus—"there can be no assurances." Microsoft Corp., a technological sophisticate if there ever was one, lost source code in the recent, and evidently still continuing, SolarWinds, Inc. hack. Sony Pictures Entertainment, Inc. lost face, and more, in the infamous 2014 hack. If the attackers, allegedly North Korean, had fun exposing studio gossip about Angelina Jolie, imagine how much more fun they'll have filching a few hundred billion dollars' worth of bitcoin.

Anyway, price appreciation is the token's No. 1 functionality today. It isn't a currency and—in its purely speculative role—it couldn't be. A proper currency facilitates lending and borrowing and spending. Crypto evangelist Elon Musk promises you'll be able to buy a Tesla one day with bitcoin, but how many times an hour is the EV maker prepared to adjust its BTC-denominated sticker prices?

Then, too, wonders reader Paul Isaac, how would Musk account for warranty obligations? And which side in the imagined transaction would bear the cybersecurity risk?

As for lending and borrowing this cyber substance, who would do that? Well, Michael Saylor is buying it with borrowed dollars, and others are no doubt following his lead. But perhaps not even Saylor would take out a bitcoin-denominated mortgage. As BTC makes gold-mining look environmentally responsible, so does it make fiat currency appear stable.

Digital jumping bean



sources: The Bloomberg, CoinMarketCap.com

More than just a dancing light on a Bloomberg screen, bitcoin is the most volatile traded item on planet earth. Nothing comes close to it. Volatility, as no *Grant's* reader needs reminding, is the standard deviation of returns multiplied by the square root of the number of periods in the trading time horizon. For the likes of stocks and bonds and currencies, the trading horizon is 252 days a year. For the sleepless bitcoin, the horizon is 365 days, except on a leap year. Thus, with this advantage in trading days (certainly an advantage when the price is going up), bitcoin weighs in with a 30-day volatility reading of 104%, compared with 4.2% for the iShares 7-10 Year Treasury Bond ETF, 4.9% for the DXY dollar index, 15% for the S&P 500 and 16.2% for gold.

In order to come up in the world, bitcoin had to pay the price for its renegade days. No federally regulated bank would accept the newfangled crypto asset whose business model harped on anonymity and which facilitated transactions across the national borders of places you wouldn't want to visit. To negotiate the dollars-to-crypto obstacle, ingenious minds contrived a payment vehicle that a bank would accept. The largest and most controversial solution was—and remains to this day—the "stablecoin" called tether. Supposedly, there is a green dollar bill standing directly behind every dollar of tether, of which $32 billion's worth are currently in use. Thus, the workaround: Buy tether with dollars; then, with tether, buy bitcoin.

Suffice it to say that many doubt the existence of any such hoard of collateral as that implied by a circulating volume of $32 billion, and *Grant's* is in the vanguard of these skeptics (see the issue dated Oct. 2, 2020). A 2019 analysis, by professors John Griffin at the University of Texas and Amin Shams of Ohio State University, titled "Is Bitcoin Really Un-Tethered?," speculates that it's uncollateralized (and therefore counterfeit) tether, not real dollars, that financed the bitcoin run-up. For the past two years, the New York State Attorney General Letitia James has been investigating some of these same allegations. Andy Kessler, writing in *The Wall Street Journal* on Jan. 31, speculates that James might shortly lay her cards on the table.

Meanwhile, the work to integrate bitcoin into the normal channels of regulated finance proceeds. Certainly, it's hard to ignore a market cap of $903.7 billion, supposedly on its way to $9 trillion or so, at which point bitcoin would match the value of all the gold mined since Cleopatra's time.

With BNY Mellon tossing its hat into the digital ring on Feb. 11, one can almost imagine bitcoin's path to respectability. The clearing bank, which traces its founding to Alexander Hamilton, announced its intention to create a "front-to-back ecosystem" for cryptocurrencies. Mastercard has pledged to support "select cryptocurrencies." The looming IPO of Coinbase, America's largest cryptocurrency exchange, would represent another step towards normalization. "Bitcoin is emerging from the shadows," the *Financial Times* recently quoted a leading British bitcoin bull, Duncan MacInnes, as saying, "being co-opted by establishment institutions and becoming a legitimate alternative asset for investment portfolios."

However, the more that bitcoin conforms to the standards of regulated finance, the less it remains decentralized, autonomous and anonymous. The chipping away at anonymity may prove especially troublesome to the original business model.

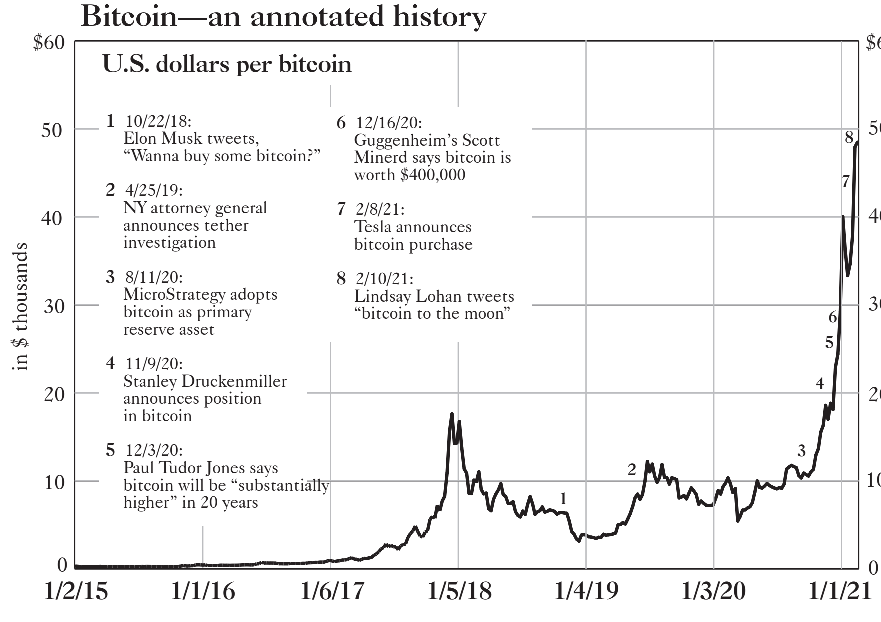
Anyone opening an account at the Coinbase exchange, or at the crypto financial-services firm BlockFi, must furnish information that no self-preserving Silk Road merchant would have dreamt of baring. James Robertson Jr. of this staff describes the procedure:

You provide an email address, then you open an email they send you to verify. You give them a mobile number, and they text you a code to enter. They ask you for the last four digits of your Social Security number, your address, the source of your funds (day job, investing, crypto mining, inheritance). Finally, they give you a timed, four-question quiz on your personal info—e.g., identify the streets closest to the address of the home in which you grew up. BlockFi's procedure is similar, but they want your three-angle mug shot, too: front and both profiles.

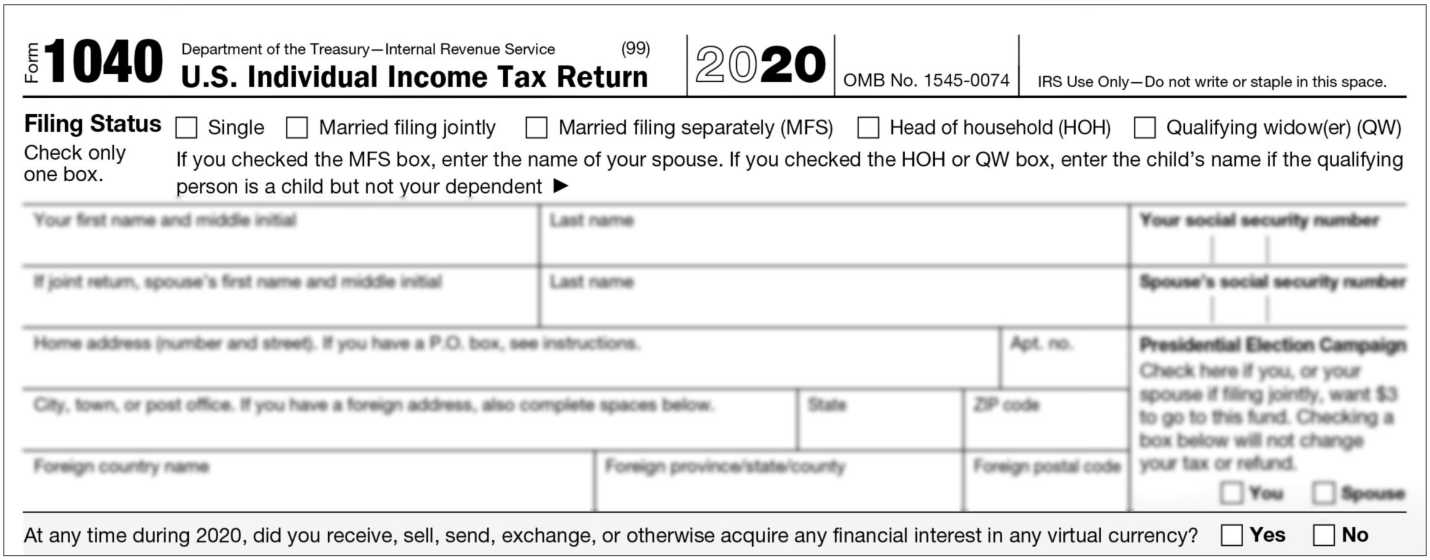
Say that you pass muster, as Robertson (of course) did. You open an account, deposit $100,000 and place an order to buy two bitcoins. Voilà! You're filled.

However, your digital portfolio does not reside in splendid anonymity on the blockchain but rather sits on subledgers at Coinbase or, perhaps, eventually, at BNY Mellon. In December, in one of his final official acts as Treasury secretary, Steven Mnuchin proposed a rule that banks and exchanges must alert the Financial Crimes Enforcement Network to details of cryptocurrency transactions exceeding $10,000 (and, in the case of a counterparty "using an unhosted or otherwise covered wallet," amounts greater than $3,000). The Biden administration has let it be known that it will make its own rules. Even so, at this political moment, the Mnuchin initiative sounds like a bipartisan crowd-pleaser. Last week, Reuters reported that 270 crypto-

Bitcoin—an annotated history



source: The Bloomberg



Form **1040** Department of the Treasury—Internal Revenue Service (99) **U.S. Individual Income Tax Return** **2020** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing Status Check only one box. ☐ Single ☐ Married filing jointly ☐ Married filing separately (MFS) ☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)

If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ►

Your first name and middle initial | Last name | Your social security number

If joint return, spouse's first name and middle initial | Last name | Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions. | Apt. no. | Presidential Election Campaign Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

City, town, or post office. If you have a foreign address, also complete spaces below. | State | ZIP code

Foreign country name | Foreign province/state/county | Foreign postal code

At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency? ☐ **Yes** ☐ **No**

currency addresses "received $1.3 billion in illicit digital coins" in 2020.

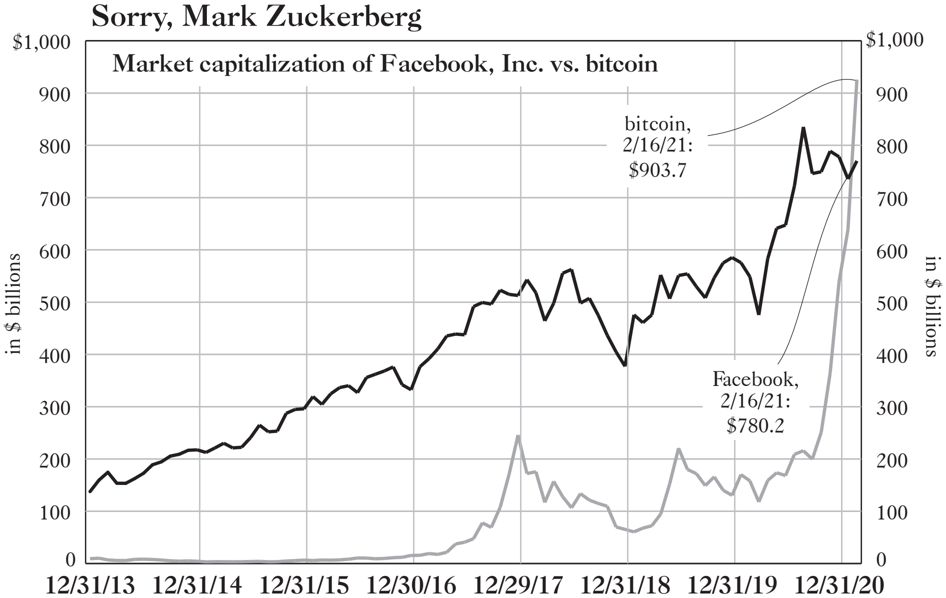
The Internal Revenue Service has been scratching at the digital door for years. Having determined, in 2018, that fewer than 1,000 electronic filers were coming clean about their cryptocurrency liabilities, the agency went to court to compel Coinbase to surrender tax-relevant records of its customers, and the exchange duly yielded.

A query on page one of the new 1040 tax form shows that the government is still on the case. "At any time during 2020," it reads, "did you receive, sell, send, exchange or otherwise acquire any financial interest in any virtual currency?" You may answer yes or no, but if you forget to tell the truth you could be liable to a $250,000 fine (peanuts to a bitcoin bull, we know) and up to three years in prison.

On page nine of the same form can be found another yes/no question, which poses, a little nostalgically: "At any time during 2020, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account or brokerage account) located in a foreign country?"

The query recalls the days of numbered Swiss bank accounts and of the bearer bonds that used to be stacked inside them. Woe betide the financial institution that, like the heavily fined and deeply rattled UBS Group A.G., finds itself in the crosshairs of federal charges of facilitating American tax evasion.

Sorry, Mark Zuckerberg



sources: The Bloomberg, CoinMarketCap.com

So you, the bitcoin-owning customer in this time of institutional evolution, must pay taxes on your winnings on a realized basis. It is a disappointment, but there are some offsetting advantages. You can hedge your tokens with futures contracts and perhaps, in the fullness of time, with crypto ETFs.

Leverage, too, is available, though not on the easiest terms. To understand the risks entailed, only put yourself in the shoes of the crypto margin clerk. He or she goes home on Friday night wondering where BTC might be trading in the wee hours of, say, Sunday. If it crashed, who'd be awake to answer the margin call? Who'd send it? To a collateralized lender, the hyper-volatility of bitcoin translates into credit risk.

Whatever the details of the ongoing institutionalization of bitcoin, the Nakamoto business model is obsolete. Everything is, or shortly will be, inverted. It's a "perfect system," true believers said of the legacy vision. "It's distributed, it's autonomous, there is no central authority." However, to achieve the scale that would justify that $400,000 price target, there must be a central authority or authorities—Coinbase, CME, BNY Mellon, what have you—and there can be no anonymity. The hodlers must pay their taxes. The margined hodlers must be marked to market. Normal tax withholding rules must apply. You need to clear, you need to settle, you need custody, you need to record and you need to report. The Silk Road, it's not.

Could the coming transition from

greed to gravity resemble the GameStop dynamics of a few weeks ago? "[U]nless system-wide adoption and outstanding volumes increase significantly from current levels," noted a Depository Trust & Clearing Corp. white paper, dated September 2018 and titled, "The Next Crisis Will Be Different," "the potential for a cryptocurrency crash or operational incidents to affect financial stability remains fairly limited."

Since the DTCC declined to come to the phone to update that assessment, we will venture an answer ourselves. At its peak, on Jan. 27, GameStop boasted a $24.2 billion market cap, yet the collapse of the share price not only stressed Robinhood and its customers but also raised questions about the clearing and margin infrastructure of the stock market itself. The crash of an asset valued at more than $900 billion, and hypothecated, and perhaps rehypothecated, in ways unknown, would likely pop no fewer financial rivets than GME did.

"The more intense the craze, the higher the type of intellect that succumbs to it," was a verdict on the best and the brightest during the bull market of the Coolidge and Hoover era, but it applies to all financial eras and to every frenzy. A bubble is a bubble, and a human is a human. The bitcoin bubble, one of history's biggest, has naturally ensnared the who's who of established finance. Wherein lies the trouble.

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