RENMAC
RENAISSANCESECTORRESEARCH

Global Equity Research
Industry Note
Industry Update

FINANCIALS RESEARCH

May 17, 2022

Stable Coin and the SEC

KEY TAKEAWAYS

Stable coins - both collateralized where stabilization is by a shared 'reserve' of fiat and other assets and algorithmic where tactical stabilization is by co-regulation, via smart contracts, with a sister coin to absorb price volatility - have long been questionable.

For a start, stable coin reserves are not subject to the registration and disclosure requirements of money market mutual funds that they resemble with the exceptions that: (i) coin-interests are recorded on a chain not a server; and (ii) coin-holders do not have a direct claim on reserve interest.

Algorithmic coins are especially problematic. The notion that a coin (e.g., Terra) can be stabilized through absorbing price volatility in a sister coin (e.g., Luna) depends, obviously, on demand for that sister coin. If such demand is supported through offering returns that are funded, in turn, by issuing more coin the optics share a characteristic of a pyramid.

In the case of Terra, demand was reportedly supported by subsidizing a minimum savings yield, once 18% (on the Anchor platform), through transfer payments funded by affiliates of the Luna minting-entity; there is likely transmission to demand for Luna itself since Luna-holders have claims on Terra seigniorage and can post Luna as collateral to borrow Terra for redeposit in a savings account.

Regardless, as SEC-Chair Gensler commented today, 'there's a need to bring greater investor protection to these crypto markets.' This note looks at the case for SEC regulation of stable coin.

Ratings

Howard Mason
212.537.8814
hmason@renmac.com

Stable Coin and the SEC

The debate around crypto-regulation is typically framed as a balance between the benefit of free markets and the need to protect: (i) investors against moral hazard and fraud; and (ii) the system against run-risk and illicit finance. After last week, it seems old-hat: the collapse of the Terra (UST)/Luna stable coin protocol, generating losses approaching $60bn, cries out for supervision.

Whether the SEC has jurisdiction turns on whether a coin meets the legal definition of a security under the 'Howey' test. It does if it arises from an investment of money in a common enterprise that is expected to generate a profit from the efforts of others. The Terra/Luna experience clarifies that stabilization relies ultimately on such a third-party, here the Luna Foundation Guard (LFG), even for algorithmic coins; asset-backed coins, of course, depend on a collateral or 'reserve' manager.

In 2018, then-SEC Chair Jay Clayton said that crypto-currencies are 'replacements for sovereign currencies, replace the dollar, the euro, the yen with bitcoin ... that type of currency is not a security.' A true currency does not involve the investment of money in a common enterprise so falls outside the definition of a security.

But this is not the case for stable coin: for a collateralized coin, such as Tether (USDT) or USDC, the proceeds of a coin mint flow to the reserve that backs the coin, and the coin represents a claim on this common enterprise. Algorithmic stable coins need not have a reserve in theory but, after the Terra/Luna collapse, will in practice if they survive at all. For Terra/Luna, LFG provided reserve support for the UST peg and therefore acted as a common enterprise.

But are stable coins purchased for profit or for consumption as a payment instrument? The question is partially moot for an algorithmic coin since it has a sister coin – so Luna in the case of Terra – to absorb price volatility. This sister coin is unequivocally purchased for profit that depends on the efforts of the minting-entity to promote and, in the last resort, stabilize the stabilized coin.

There is less investment opportunity in asset-backed coins since, while value may diverge slightly from the peg to the upside (due to redemption frictions), a reasonable purchaser would not expect to hold the coin for a long period as an investment and any value appreciation is incidental to use as intended as a temporary store of value.

However, it seems perverse to exclude asset-backed stable coins from the SEC oversight that attaches to money market mutual funds *because* the entire yield from the asset pool is diverted from claim-holders to sponsors; if anything this increases, rather than reduces, the moral hazard risk faced by these claim-holders as illustrated by the controversy over the risk-content of the Tether Reserve.

Current-SEC Chair Gary Gensler cuts this gordian knot by making the obvious remark that asset-backed stable coins are repackaging the securities held in the reserve, and so are derivatives hence themselves securities: 'Make no mistake: It doesn't matter whether it's a stock token, a stable value token backed by securities, or any other virtual product that provides synthetic exposure to underlying securities ...these platforms — whether in the decentralized or centralized finance space — are implicated by the securities laws and must work within our securities regime.'

In the way of the Terra/Luna collapse, he reiterated this conviction today: 'there's a need to bring greater investor protection to these crypto markets ... central to that are crypto trading and lending platforms, where investors buy, sell and lend around $100 billion of crypto assets a day. The crypto-related events in recent weeks have highlighted yet again how important it is to protect investors in this highly speculative asset class.'

ANALYST(S) CERTIFICATION(S): I, Howard Mason, herby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

AFFILIATE DISCLOSURES: RenMac is the trade name and registered trademark under which research and services of Renaissance Macro Holdings and its subsidiaries Renaissance Macro Securities, LLC and Renaissance Macro Research, LLC are marketed. This report has been prepared by Renaissance Macro Securities, LLC. Renaissance Macro Securities, LLC is regulated by FINRA and the United States Securities and Exchange Commission. Disclosures in this section and in the Disclaimer section referencing RenMac include all subsidiaries unless otherwise specified.

IMPORTANT DISCLOSURES: The analysts responsible for preparing this research report received compensation based on various factors, none of which is revenue generated by investment banking activities. RenMac is not engaged in any investment banking activities at this time. Analysts regularly conduct site and company visits to review the operations of the company and discuss financial and strategic plans with management, but RenMac's policies prohibit them from accepting payment or reimbursement for their travel expenses. RenMac produces many types of research including, but not limited to, fundamental research, quantitative research, Washington Policy, Economics and Technical Research. Recommendation in one type of research product may differ from recommendations contained in other types of research products whether as a result of differing time horizons, methodologies, or otherwise.

Companies Mentioned:

Price target and Valuation Methodology: Each Analyst has a single price target in all of the stocks that they cover. The price target represents that Analyst's expectation of where the stock will trade in the next twelve months.

We use a variety of valuation methodologies to arrive at our price targets including an enterprise value multiple of estimated future EBITDA and a tangible book value multiple of estimated return on tangible common equity.

Risk Disclosure(s):

Key risks for banks and payment companies include changes in interest and currency rates among other market factors, the willingness and ability of borrowers and derivative counterparties to make good on due amounts, legal risks related to conduct and compliance with governmental requirements including those related to banking and money-transfer licenses such as know-your-customer and anti-money-laundering controls, structural shifts in competitive dynamics, and regulatory and other constraints on the ability to return capital to shareholders. We refer clients to the relevant SEC filings of covered companies, including in particular the 10-K reports, for a more complete discussion.

Guide to RenMac's Fundamental Research Rating System: Our fundamental coverage Analysts use a relative ranking system to rate stocks as Buy, Sell or Hold (see definitions below) relative to other companies covered by the Analyst or are deemed to be in the same industry (the Analysts Coverage Universe). In addition to the stock ratings each Analyst provides an Industry Ratings which provides the outlook for the industry coverage as Positive, Neutral or Negative (see definitions below). Investors should carefully read the entire research report including the definitions of all ratings and not infer its content from ratings alone.

Stock Ratings:

Overweight – The stock is expected to outperform the un-weighted expected total return of the industry coverage universe over the next 12 months.

Equal Weight – The stock is expected to perform in line with the un-weighted expected total return of the industry coverage universe over the next 12 months.

Underweight – The stock is expected to underperform the un-weighted expected total return of the industry coverage universe over the next 12 months.

Ratings Suspended - The ratings and price target have been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and /or firm policy.

Distribution of Ratings:
As of May 17, 2022, RenMac has 8 companies under coverage.
50% have been assigned an Overweight Rating. 50% have been assigned an Equalweight Rating. 0% have been assigned an Underweight Rating. None of the companies under coverage are Invetment Banking clients.

Industry Rating:

Positive – Industry coverage universe has improving fundamentals and valuations.

Neutral – Industry coverage universe has neutral fundamentals and valuations.

Negative – Industry coverage universe has deteriorating fundamentals and valuations.

DISCLAIMER: This document has been prepared by Renaissance Macro Securities LLC, a subsidiary of Renaissance Macro Holdings, LLC. This document is for distribution only as may be permitted by law. It is published solely for information purposes; it is not an advertisement nor is it a solicitation or an offer to buy or sell any financial instruments or to participate in any particular trading strategy. No representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness or reliability of the information contained in this document. The information is not intended to be a complete statement or summary of the markets, economy or other developments referred to in the document. Any opinions expressed in this document may change without notice. Any statements contained in this report attributed to a third party represent RenMac's interpretation of the data, information and/or opinions provided by that third party either publicly or through a subscription service, and such use and interpretation have not been reviewed by the third party. Nothing in this document constitutes a representation that any investment strategy or recommendation is suitable or appropriate to an investor's individual circumstances or otherwise constitutes a personal recommendation. Investments involve risks, and investors should exercise prudence and their own judgment in making their investment decisions. The value of any investment may decline due to factors affecting the securities markets generally or particular industries. Past performance is not indicative of future results. Neither RenMac nor any of its directors, employees or agents accept any liability for any loss (including investment loss) or damage arising out of the use of all or any of the information. Any information stated in this document is for information purposes only and does not represent valuations for individual securities or other financial instruments. Different assumptions by RenMac or any other source may yield substantially different results. The analysis contained in this document is based on numerous assumptions and are not all inclusive.