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Bitcoin's unfortunate liquidity problem, as inadvertently highlighted by an SEC order

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The SEC has issued a cease and desist order against Bitcoin Investment Trust (BIT) and SecondMarket, both founded by Digital Currency Group CEO Barry Silbert — and dubbed back in September 2013 by the NY Times' Peter Lattman and Nathanial Popper as "a reliable and easy way to bet on the future price of bitcoin".

The Trust famously beat the Winklevoss brothers' bitcoin ETF to market and drew significant column inches as a result. The Winklevoss ETF (*for some strange reason associated possibly with risk?*) is yet to receive regulatory approval, forcing the brothers to make significant amendments to their original regulatory filing if it's to stand a chance of being approved.

Integral to BIT's "first to market" win, though, was its private placement structure.

And herein lies the rub for Silbert. In the US, public security offerings are tightly controlled — all the more so if liquidity guarantees are being made. All public securities must be registered with the Securities and Exchange Commission and comply with all necessary reporting requirements.

BIT shares were private placement securities, however, so they were never registered. Liquidity guarantees were made in a limited capacity via BIT's relationship with SecondMarket, its designated "Authorized Participant" or AP, but only for shares held for more than a year.

From the SEC order (our emphasis):

> BIT shares purchased by anyone other than an AP had limited liquidity. As explained in a footnote in the investor deck, liquidity was limited due to the fact that neither BIT nor its offering of shares are registered with the Commission and at the time, there was no public trading market for BIT shares. **Nevertheless, BIT intended to offer liquidity for shares held less than one year through some undetermined mechanism.** The investor deck stated that liquidity for shares is "to commence no later than March 2014." Beginning in November 2013, SecondMarket received requests for liquidity from shareholders. **In response to those requests, BIT sought and received legal advice from outside counsel regarding the development of a shareholder redemption program.**

The problem cascaded from there on.

Investors in BIT wanted liquidity. But there was no public market in BIT shares.

To get around this, BIT announced on March 19, 2014, a limited redemption schedule for holdings of less than one year while at the same time applying to qualify BIT shares for public trading on the OTC Market Group's marketplace, triggering a restricted trading period according to SEC rules.

Accordingly, SecondMarket was given sole discretion to set and thereby limit the number of shareholders' shares redeemed during each month. As the SEC notes, during the period April 2, 2014 through September 4, 2014, SecondMarket, in its capacity as BIT's Authorised Participant, purchased a total of 85,721 BIT shares in connection with redemptions made by BIT shareholders. They add that SecondMarket earned a total of $51,650.11 in fees in connection with these shareholder redemptions.

When the SEC notified SecondMarket in September 2014 that this arrangement violated Regulation M, BIT suspended the redemption programme.

In short, the redemption programme broke Rule 101 of Regulation M which is designed to prevent manipulation of a security before an offering, by regulating issuers' and underwriters' activity during a restricted period ahead of the issuance.

BIT's shares were about to list on the OTC Market Group marketplace, which meant they were subject to a restricted period: SecondMarket wasn't permitted to purchase shares during that time. Essentially, they weren't allowed to provide liquidity to BIT investors. In the eyes of the SEC**,** BIT's initial offering constituted a distribution, both due to its magnitude and the special selling efforts and methods used to facilitate the distribution.

SecondMarket, as a result, has been ordered to pay $53,755.79 to the SEC. In terms of violations, it's not a biggie.

There is, however, a more significant story behind the scenes pertaining to the general liquidity of bitcoin and bitcoin investments.

Silbert, for example, has publicly stated that he believes Bitcoin's future as a reliable payment rail depends on it drawing liquidity and investment. Yet in saying this Silbert demonstrates a small misunderstanding in how payments really work and who really underwrites (if not outwardly funds) the payment rails.

Indeed, as former deputy governor of the BoE Paul Tucker has expressed, banks need huge swathes of voluntarily subordinated creditors/investors if those using their shares/equity operationally as "payment rails" are to be protected from becoming inadvertent loss-absorbing equity investors if and when liquidity vapourises or imbalances pop up.

Banks generally entice such creditors by offering them a return on capital invested, as sourced from revenues earned from the redeployment of surplus funds to productive ventures, as well as other associated and complimentary services for which fees are charged. Another important creditor enticement has also always been a senior ranking over inadvertent creditors like depositors.

If bitcoin is to become a sustainable payment system it too, however, will need large swathes of subordinated and patient ~~bagholders~~ creditors to buffer the imbalances in the system. Thus far bitcoin has benefited in this regard from the long-term sticky capital donated to it by the ideologically motivated and mystically inclined.

Their investment choices are driven by beliefs, not income. But, as the BIT episode shows, the more institutional and sophisticated bitcoin investors get, the greater the demands for liquidity and seniority get.

That's a problem for bitcoin, the value of which is closely tied to the unsophisticated nature of its investor base and its illiquidity.

Unfortunately, in the real world, there are only so many investors who are prepared to lock their capital away for the long term without any compensatory income in return. All the more so, of course, if they know that the capital stock isn't actually being invested into anything productive or with earning potential (see the bitcoin schism, over the community's reluctance to hike fees for its payment services).

Sophisticated investors will also understand that without a viable earnings model to cover the huge energy costs of the system, their investments stand a very good chance of becoming charitable donations to the cause of Satoshi in the long run. To play the speculative bubble game and come out on top, they will need liquidity.

Sadly for bitcoin, the more market liquidity there is, the more price discovery there will be too. So, unless bitcoin comes up with a viable earnings strategy or something akin to a productive return on capital pretty sharpish, the price that's discovered could very well disappoint a more sophisticated investor base.

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