

Insights

WEB 3 - THE END OF THE BEGINNING

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At the beginning of this year we were asked by a client to advise on a new project – the tokenisation, and sale in the form of NFTs, of a previously illiquid asset. The project is ground-breaking and is the first time that this type of asset has been sold in digital token form.

Our project is now very close to launch. While we have been working on this project, cryptocurrency valuations have collapsed, the speculative mania surrounding NFTs has dissipated and the FTX implosion has taken place. However, we believe that projects such as this one – creating digital assets of substance – will be a central part of the next phase of Web 3.

In this article, we argue that this may mark the “end of the beginning” for Web 3. In other words, that the historic Web 3 era of digital asset speculation, poor governance and weak regulation is coming to an end. We suggest it will be replaced by an industry creating products and services of real value built on distributed ledger technology. Appropriate regulation and responsible and robust business models will be essential to support mainstream adoption, as will a paradigm-shift in the user experience.

Contrary to what some have suggested, we believe that recent events do not evidence the end of the digital asset economy. Rather, this period is a necessary part of its evolution from an experimental technology, which generated irrational euphoria and an associated asset price bubble, to mainstream adoption grounded in reasonable assessments of the usefulness of the underlying technology and providing innovative solutions to a range of real world applications.

CRYPTOCURRENCIES

It should now be clear that the price of Bitcoin and other cryptocurrencies from the middle of the last decade until earlier this year was driven by unsustainable demand and not supported by underlying fundamentals – the classic characteristics of an asset price bubble.

Many early enthusiasts saw Bitcoin in philosophical terms – a decentralised currency beyond state control or interference and with a controlled and finite supply, meaning that it cannot be debased through “money printing” or similar government or central bank action. The claim that Bitcoin and

other cryptocurrencies would “democratise” money was often made by the more evangelical segment of the crypto community.

However, in time, financial speculation took over, leading to incredible increases in the price of Bitcoin. The original price of Bitcoin in 2011 was \$0.30. The Bitcoin price began 2013 at \$13.30 and rose to \$770 by 1 January 2014, a rise of nearly 5,700% in a year. Later, the Bitcoin price increased from \$998 to \$13,412 over the year to 1 January 2018 (a rise of nearly 1,250%). The all-time high was in excess of \$65,000 in November 2021, with the price currently back at approximately \$17,000.

Bitcoin works extremely poorly as a medium of exchange and, as has been well-documented, it carries a huge environmental footprint. Its primary use (other than for trading and speculation) is therefore as a store of value, albeit an extremely volatile one. However, it could be argued that Bitcoin’s attractiveness and usefulness, even on that basis, is likely to come to an end sooner rather than later. Arguably, the blockchain on which Bitcoin is built is not appropriately scalable, or fast enough, to facilitate blockchain-based solutions other than Bitcoin-like cryptocurrencies. Existing technology can and will be replaced by better alternatives as they are developed. It is not clear that Bitcoin has unique features that will make it impervious to such forces.

Time will tell how cryptocurrency markets develop. However, it is logical to assume that many users will wish to use digital currencies with low environmental impact and high standards of governance and oversight. Stablecoins and other asset-backed cryptocurrencies may be a part of that landscape. Of course, the ecosystem of service providers that has already developed to facilitate the holding, exchanging and trading of digital assets will adapt and evolve to serve these markets.

USE CASES

The use cases for blockchain technology are still being explored, but already it seems likely that numerous industries will be disrupted.

In decentralised finance (DeFi), activities including borrowing and lending, payments and insurance are already taking place through blockchain-based solutions. These services can offer benefits of efficiency, which should increase as they become more developed. There is also scope for extensive product innovation and both the entrance of new market participants (for example, through peer-to-peer activity) and the disintermediation of traditional providers will inevitably lead to greater competition in relation to pricing and terms.

Likewise, in the trading, clearing and settlement space for securities and other financial instruments, including derivatives, DLT has the potential to improve efficiencies and provide significant cost savings to both financial institutions and financial market infrastructure providers. Much of the complex web of the existing financial market infrastructure is based on a diverse range of legacy technologies being used by different financial institutions in different ways. This leads to automation being stifled by the need for excessive manual intervention to address issues when the

disparate technological platforms across the ecosystem do not interact with one other as intended. A DLT-based solution could overcome much of this.

Distributed ledger technology has the potential to become the new norm for maintaining numerous types of ledgers and registers (such as share registers and registers of property ownership) and to be widely adopted in the logistics and procurement industries. Work will be required to refine these solutions and to implement them at scale, but the opportunity has already been widely identified and that work is under way. Indeed, a number of such solutions are already in operation.

Asset tokenisation is an area with huge possibilities. As well as the possibility of fractionalising and tokenising previously illiquid asset classes, smart contract technology creates enormous potential for innovation. Entirely new types of products will be created, potentially fusing property rights and contractual rights and real world and digital interests in previously unimaginable ways. The possibilities here are literally endless.

The ability, using smart contracts, to digitally embed rights is particularly powerful. For example, allowing the creator of a piece of digital property to collect a royalty each time the asset is transferred.

Finally, decentralised autonomous organisations (DAOs) will become more prevalent and appear well-suited for a range of purposes. And the technologies commonly thought of as being part of the “metaverse” will continue to develop and will inevitably become more polished, even if the use cases in that area are less well-articulated at present.

USER EXPERIENCE

The emergence of centralised cryptocurrency exchanges has made buying, holding and trading of digital currencies much easier. However, there remain significant barriers to mainstream participation in the digital asset economy.

Centralised exchanges vary hugely in features such as governance, regulation and security. In mainstream markets, for example retail banking, consumers have to assess well-understood metrics when making a purchasing decision, such as fees, interest rates and customer service – a simple task. In most developed economies, it is generally assumed that online transactions will be safe and secure.

The due diligence requirements when selecting service providers in the digital asset economy are much greater and fraudulent activity is widespread. In addition, accessing many products and services currently requires a level of technical expertise that most people do not possess and an investment of time that the majority of consumers are not willing to make.

Crypto, DeFi and Web 3 are inherently innovative industries. They will undoubtedly create compelling products and services over the coming years which disrupt existing business models.

The vast banking and finance industries (so-called “TradFi”) appear particularly susceptible. The size of DeFi markets is currently miniscule compared to conventional banking and finance, but DeFi has the potential for rapid growth as the technological possibilities are harnessed.

However, for this growth to be achieved, services need to be accessible and trusted. User experience is becoming a hot topic and we expect that talented developers and entrepreneurs will move the dial in this area in the next few years. We hope that means blockchain-based services and products that are presented in plain English and accessible without technical expertise. We also anticipate much more seamless interaction between digital assets and the mainstream financial ecosystem.

This step-change in user-experience and consumer confidence would appear to be non-negotiable if the industry is to cross-over into mainstream adoption.

REGULATION

For several years there have been calls by many to regulate the crypto asset industry on consumer protection grounds. More recently, as the size and significance of the digital asset sector grew exponentially, international and domestic prudential financial regulators have been increasingly concerned about the potential for systemic risk to cross over from the crypto world and contaminate the mainstream financial services sector. The rise in the use of stablecoins within the digital assets industry, designed primarily to help increase speed and reduce friction in making payments, has been a significant concern for those regulatory bodies concerned with financial stability.

Notwithstanding the above concerns, the regulatory response globally has been slow and piecemeal when any action has been taken. This has been caused by several factors including the fact that some law makers and regulators are concerned about potentially crushing this nascent industry with overly burdensome regulation and thereby destroying the potential benefits DLT might bring. Further, in the UK for example, the FCA has generally held a negative view of cryptocurrencies but has felt that it does not have the power to regulate the sector without new legislation. Moreover, the FCA has publicly stated that it does not want those powers to regulate cryptocurrencies unless it is also given appropriate resources and expertise to be able to do so effectively.

Nevertheless, as things currently stand, regulation of the crypto asset sector is not entirely absent. Many jurisdictions have pieces of regulation that apply to certain aspects of the digital assets ecosystem. For example, many jurisdictions have rules that apply to the crypto asset sector for the prevention of financial crime and money laundering. Likewise, many jurisdictions have bespoke rules in the pipeline to regulate stablecoins and the marketing of crypto assets to consumers.

Events over the course of much of 2022, culminating in the collapse of FTX, have however laid bare the inadequacies of the current patchwork regulatory framework. Given the allegations of outright fraud and embezzlement that have been levelled at Sam Bankman-Fried, effective regulation may not have prevented the collapse of FTX per se. However, sensible and effective regulation gives

consumers and market participants a choice about which service providers they want to interact with. A service provider that is regulated under a legitimate licensing regime overseen by a regulator of international standing can give consumers and institutions the confidence they need to engage with the digital assets sector in a constructive manner. They do not have to rely solely on the "say so" and bluster of those that profess to be the guardians of the industry.

In addition, an effective regulatory regime helps to protect and enhance the standing of those industry participants that are operating on a legitimate and robust basis, with appropriate oversight and governance and looking at the longer term prospects for the sector. Increasingly these legitimate players have been hiring people with TradFi backgrounds and imposing standards on themselves that are akin to many of those found in the mainstream financial services sector (e.g. in relation to the segregation of client assets and funds). Notwithstanding these efforts, without appropriate top-down regulation, the industry is unlikely to generate the credibility and consumer confidence necessary to sustain itself and to allow it to develop further. The recent collapses and the outflows of funds from the sector following the FTX debacle is clear evidence of this.

In short, the time for comprehensive regulation of the crypto asset sector has arrived.

In what is arguably the most comprehensive regulatory package for crypto assets in play at the moment, the EU is about to finalise its Markets in Cryptoasset Regulation (MiCA). MiCA will provide a comprehensive regime for crypto asset firms, stablecoin issuers and issuers of other digital assets. Amongst other things, this regime will cover the licensing of crypto asset firms, the public offer of digital assets, organisational requirements for crypto asset firms such as governance and oversight requirements and a market abuse regime for digital assets trading.

While it remains to be seen whether other jurisdictions will follow a similar path to that of MiCA, what is clear is that something much more comprehensive than what is currently in place will need to be created. While there are challenges in regulating crypto assets founded on DLT, these types of challenges are not uncommon in the area of financial regulation. Regulators can create rules which can be adapted and fine-tuned over time as their impact is better understood and associated market practices develop. Getting the balance of regulation right is difficult but it should not result in inaction given what has transpired over the last year. A failure of law makers and regulators to take bold action now will not only increase the potential for consumer harm and market instability but may also undermine the digital asset industry itself, where many legitimate industry players have been calling for sensible regulation for some time to create a clearer delineation between the good, the bad and the ugly.

CONCLUSION

In short, we believe that 2022 will be seen as a turning point at which the experimental and speculative phase of Web 3 substantially comes to an end and the process of creating a grown-up industry commences in earnest.

If one looks to the “dot-com revolution” as a precedent, it is clear to see the trajectory that the Web 3 industry may follow as it ceases to be the domain of early adopters and tech-savvy enthusiasts and begins its journey to being part of the mainstream economy. The dot-com era also provides numerous examples of how irrational exuberance and idealism give way to pragmatism and real world applications, as revolutionary new technology initially disrupts existing business models and subsequently becomes an accepted part of the status quo.

We believe that a similar trajectory for Web 3 is inevitable.

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MEET THE TEAM



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