

Withdrawal of Staked Ether and Related Rewards Expected in Early April

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Unlocking of Staked Ether Expected to Create a Benchmark Yield for the Digital Assets Industry

Since the Ethereum network underwent a transition in the way it validates transactions from proof-of-work (PoW) to proof-of-stake (PoS) in September 2022, it has been possible for validators to stake Ether (ETH) in a smart contract, but it has not yet been possible to withdraw the staked ETH or earned rewards. A new upgrade to the Ethereum network called the Shanghai Upgrade, or Ethereum Improvement Proposal EIP-4895, is expected to change this in early April 2023.

We believe this upgrade will be significant for the industry, as it creates a yield against which all other token yields can be benchmarked. Although the staking and withdrawal of rewards have been enabled by many other tokens, Ethereum remains the most widely adopted smart contract blockchain and has more than double the number of total developers compared with any other blockchain network.¹ Because Ethereum accounts for 19% of the total crypto market and has a \$204 billion market cap,² the asset is fairly liquid and arguably remains one of the favorite assets to own among institutional investors, along with Bitcoin.

Will Unstaking Create Unusual Selling Pressure on ETH?

Currently, the amount of ETH that has been staked on the PoS Beacon chain is more than 16.7 million ETH or more than \$27 billion via over 520,000 validators.³ This is only approximately 14% of the total ETH in circulation, which is a much lower staking ratio than with many other tokens, where the ratio is more typically 40%–98%.⁴ It is estimated that 65% of staked ETH tokens are already liquid,⁵ as many validators have issued staked ETH tokens that can be used for decentralized finance (DeFi) applications, etc. The largest ETH validator is a liquid staking pool provider, Lido Finance, with more than 30% market share, followed by centralized exchanges Coinbase, Kraken and Binance.⁶ Of centralized exchanges, Coinbase and Binance have offered staked ETH tokens and, hence, liquidity to ETH stakers.

When the Beacon chain came alive in December 2020, an estimated 2 million ETH was staked⁷ on the chain with an average ETH price of \$600.8 and these ETH stakers, along with some other early investors, are now in profit. While some of them might be under pressure due to tumultuous crypto price changes last year, significant pricing pressure may not come from this group. These investors are likely to be “true believers” in Ethereum as they took the risk of investing early while not having any firm visibility into when staking rewards could be collected. In addition, we estimate that close to 70% of ETH stakers invested in 2021 and early 2022, and these investors are still underwater. Hence, a majority of these investors may not exit at a loss.

Will Unlocking Create a Situation Where One Validator Could Control >50% of Ethereum Blockchain Transaction Validations?

It may be hard to believe that will be the case, as exiting the Beacon chain will be managed by a staged process. Two types of withdrawals will be possible once the withdrawal of ETH and associated staking rewards is enabled. The first option includes a partial withdrawal, where a validator withdraws the staking reward but leaves the staked ETH untouched. There is an estimated 1 million ETH in accumulated staking rewards⁹ so far, amounting to \$1.7 billion in potential selling pressure at a current ETH price of \$1,656.10. Because ETH's daily average volume is about \$13 billion¹¹, it may be unlikely that this will be a major threat to ETH's price, particularly considering that this exit flow is likely to take place over days or weeks.

Another type of withdrawal is a full exit, where an investor exits both the staking reward and the staked ETH deposit. To counteract the potential instability of the network during the exit period, the Ethereum blockchain has imposed limits on these exits. The network is programmed to limit exits to seven validators per epoch, which is 6.4 minutes, and this means that a maximum of 1,575 validators can exit the network per day.¹² As there are more than 520,000 validators in total, the limited number of daily exits may not destabilize the blockchain and/or enable malicious attacks.

With Staking Services under Threat in the U.S., Should They Be Considered Securities?

In February 2023, Kraken was sued by the Securities and Exchange Commission (SEC) for failing to register the offer and sale of its Staking-as-a-Service program as a security in the U.S. Kraken chose to settle this charge, end all of its on-chain staking services for U.S. clients and pay a \$30 million fine. Kraken is the third-largest validator of ETH transactions and has approximately 9% market share of the 16.7 million ETH locked in a smart contract network.¹³ Kraken's exit from the U.S. will force investors to find an alternative way to stake ETH, which may benefit liquid staking providers, such as Lido Finance and Rocket Pool.

There appears to be some confusion in the market around how staking products should be viewed, and it could be the case that not all staking products should be viewed in the same way. Some may argue that all “yield,” “earn,” “annual percentage yield” and “staking” products should probably be treated as securities. According to publicly available information, Kraken's staking program offered an annual fixed yield, paid twice a week,¹⁴ and this was different from the actual yield and frequency of payment made by the underlying Ethereum protocol.

If all staking programs are viewed as securities, it may harm digital asset market participants like Coinbase, which serves as the second-largest individual ETH validator and derived 11% of its net revenues from staking activities (not just Ether tokens, though) in Q3 2022, according to their public company financial reporting documents.¹⁵ Staking can be a high-margin business; hence, the potential impact on the profitability of digital market participants like Coinbase may be even greater. In fact, digital asset market participants like Coinbase may argue that its staking service should not be viewed as a security because it does not commingle client funds and it pays the same reward as the underlying blockchain minus a transparent fixed fee.

1 Source: Electric Capital, Developer Report 2022.

2 Source: CoinMarketCap, 2/17/23.

3 Source: Beaconcha.in, 2/17/23.

4 Source: Defi Llama, Stakingrewards.com.

5 Source: Nansen.

6 Source: Nansen.

7 Source: CryptoQuant.

8 Source: Bloomberg.

9 Source: Stakingrewards.com.

10 Source: Bloomberg, 2/17/23.

11 Bloomberg, 2/17/23.

12 Source: Ethereum.org.

13 Source: Nansen.

14 Source: support.kraken.com.

15 Source: Coinbase, Q3 2022 financials

Important Risks Related to this Article

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There are risks associated with investing, including the possible loss of principal. Crypto assets, such as bitcoin and ether, are complex, generally exhibit extreme price volatility and unpredictability and should be viewed as highly speculative assets.

Crypto assets are frequently referred to as crypto “currencies,” but they typically operate without central authority or banks, are not backed by any government or issuing entity (i.e., no right of recourse), have no government or insurance protections, are not legal tender and have limited or no usability as compared to fiat currencies. Federal, state or foreign governments may restrict the use, transfer, exchange and value of crypto assets, and regulation in the U.S. and worldwide is still developing.

Crypto asset exchanges, liquidity providers, networks, protocols, settlement facilities, service providers and other participants in the digital asset ecosystem, and/or crypto assets related to the foregoing, may stop operating, permanently shut down or experience issues due to security breaches, fraud, insolvency, market manipulation, market surveillance, KYC/AML (know your customer/anti-money laundering) procedures, non-compliance with applicable rules and regulations, regulatory investigations or orders, technical glitches, hackers, malware or other reasons, which could negatively impact the price of any cryptocurrency

traded on such exchanges or reliant on a digital asset ecosystem participant or otherwise may prevent access or use of the crypto asset.

Crypto assets can experience unique events, such as forks or airdrops, which can impact the value and functionality of the crypto asset. Crypto asset transactions are generally irreversible, which means that a crypto asset may be unrecoverable in instances where: (i) it is sent to an incorrect address, (ii) the incorrect amount is sent or (iii) transactions are made fraudulently from an account. A crypto asset may decline in popularity, acceptance or use, thereby impairing its price, and the price of a crypto asset may also be impacted by the transactions of a small number of holders of such crypto asset. Crypto assets may be difficult to value, and valuations, even for the same crypto asset, may differ significantly by pricing source or otherwise be suspect due to market fragmentation, illiquidity, volatility and the potential for manipulation.

Crypto assets generally rely on blockchain technology, and blockchain technology is a relatively new and untested technology that operates as a distributed ledger. Blockchain systems could be subject to internet connectivity disruptions, consensus failures or cybersecurity attacks, and the date or time that you initiate a transaction may be different than when it is recorded on the blockchain. Access to a given blockchain requires an individualized key, which, if compromised, could result in loss due to theft, destruction or inaccessibility. In addition, different crypto assets exhibit different characteristics, use cases and risk profiles.

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