The Ethereum Merge Ups the Stakes—and Reshapes the Crypto Universe

Ether will pay interest and more closely resemble normal financial instruments.
By Olga Kharif and David Pan  
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Ethereum is about to get a makeover. The popular crypto network that runs Ether, the world’s second-most-valuable digital currency, could morph as early as Sept. 14 into a configuration that shakes up the entire crypto universe.
The long-anticipated software change, “the Merge” to crypto fans worldwide, will lower Ethereum’s energy use by 99%, silencing critics who dislike the blockchain for its electricity consumption—enough to power Finland for a year by one estimate.

But for investors, the advantage is that Ether post-Merge will resemble more of a traditional financial asset that pays interest, like a bond or a certificate of deposit. That could entice hedge funds, asset managers, and wealthy individuals who’ve stayed on the crypto sidelines so far. The new software will also make possible upgrades that promise to speed transactions and lower fees, another hook that could lure investors. Some enthusiasts even predict the changes, taken together, could result in Ether leapfrogging Bitcoin in value. Bitcoin, the most popular token, has a market value that’s almost twice that of Ether.

**Cryptocurrency Prices**

Change since June 1

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Source: Bloomberg

All this just from a software update? Enthusiasts say yes, based on the fundamental shift in the way Ethereum works and behaves. As first described in 2014 by Vitalik Buterin at age 20 (now a ripe 28-year-old), Ethereum’s decentralized network of computers race to solve mathematical puzzles, competing for the right to order transactions and add blocks of data to a digital ledger. Owners of the computers, called miners, make sure the ledger can’t be tampered with. In return, miners are rewarded with Ether. Bitcoin uses a similar system, called proof of work.

Ethereum’s new process will rely instead on what’s called proof of stake. It consumes very little power, because it doesn’t depend on miners. It does require entities called validators to put some skin in the game in the form of Ether coins. Staking, or putting coins in the pot, gives large Ether owners the right to add a block of transactions to the ledger; they’re rewarded with new Ether when they do so. All Ether tokens will now pay interest when placed into staking wallets. The software upgrade is called
the Merge because the existing Ethereum blockchain will combine with a parallel network that’s been running for almost two years to test the proof-of-stake concept.

Ethereum co-founder Vitalik Buterin. *Photographer: Chet Strange/Bloomberg*

To acolytes, staked Ether becomes like shares of stock that generate dividends or bonds that pay a yield. Ether’s yield could be relatively attractive: Owners who stake their coins can get about 4% now, and that’s expected to rise post-Merge. As much as 80% of all Ether supply—about $170 billion at current prices—could eventually be staked, according to ConsenSys, an Ethereum blockchain technology provider. “I think that Ethereum's merge fundamentally changes the asset,” says Jack Neureuter, research analyst at Fidelity Digital Assets, a unit of Fidelity Investments Inc. that plans to offer custody and trading in Ether later this year. “It fundamentally changes the investment case around it.”

But there are skeptics. Bitcoin purists believe the massive rush into staking is a waste. “So long as security has a cost, that cost has to come from somewhere,” says Christopher Bendiksen, an analyst at CoinShares, an asset manager. In proof of work, it comes from energy and hardware, he says, while in proof of stake “it comes from hoarding capital.”
Staking Ether is incompairably more risky than investing in, say, a US Treasury bond, says Campbell Harvey, professor of finance at Duke University. Any interest “is paid with a currency that has, like, 90% volatility, and it’s going through a major change,” he says.

Still, for existing Ether investors, staked coins will be similar to putting money to work instead of stuffing it under a mattress. The yield feature allows traditional finance professionals who’ve long struggled with valuing crypto assets to perform cash-flow analyses to compare Ether’s performance with that of traditional assets. They can also benchmark staked Ether against other investments. “It’s not risk-free, but it gets you close,” says Henry Elder, head of decentralized finance at Wave Financial Group, an investment manager. “This is something that crypto really struggled with: How do you compare asset managers, how do you compare performance? I think that’s super important, because when you get to institutional investors, that’s the language that they speak.”

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Ether’s new features could help it overtake Bitcoin in value—or “flippening” to aficionados. “I do think Ethereum will flip Bitcoin probably sooner than people think,” says Jeff Dorman, chief investment officer at Arca, a crypto financial-services firm. “Every success story you are seeing on blockchain is happening on Ethereum.” While Bitcoin has remained largely unchanged—“fossilized,” as Fidelity’s Neureuter puts it—the Merge could also solidify Ethereum’s position as the most important crypto commercial highway once additional changes make the network faster and cheaper to use. “At the end of the day, a network is only as valuable as the number of people using and deriving value from it,” says David Kroger, digital data scientist at Cowen Inc.

Staked Ether could also give rise to a slew of financial instruments. Already, in August, the biggest US crypto exchange, operated by Coinbase Global Inc., announced a derivative token representing staked Ether that users will be able to trade, lend, or borrow. In the future, it may be possible to take out a loan against staked Ether, with interest on the loan paid with staking yield. New types of staked Ether trusts, in which investors can buy shares in staked tokens, could proliferate. “It gives more and more people the opportunity to be stakeholders in Ethereum,” says Paul Veradittakit, a partner at Pantera Capital, which manages crypto hedge funds. “It can bring a larger pool of capital from traditional finance.”
There could be wrinkles, of course. Until Ethereum undergoes another software upgrade, likely six months away at least, staked Ether can’t be withdrawn. Even then, withdrawals will be limited. So yield lovers could find themselves stuck, at least temporarily. The Securities and Exchange Commission could also pounce once the coin’s properties shift. Until now, Ether’s decentralized nature—its lack of a formal intermediary—has held the regulator at bay. But the SEC’s current chair, Gary Gensler, who’s repeatedly called the “vast majority” of crypto coins securities, may see Ethereum’s changes as an opening. After all, with staked Ether, people will be investing actual money, one of the key characteristics of a security. “I definitely think this is a move that will make it far more likely that any court or regulator would view it as a security,” says Dara Tarkowski, managing partner at Actuate Law. In August, Coinbase disclosed that it received SEC subpoenas and requests for documents, some of which related to its staking program.

Adding to the uncertainty, the Merge is happening during a crypto market downturn, which has shaved as much as $2 trillion in value since November from the world’s tokens and crimped investor appetite. But if crypto’s bull market returns, Ether fans hope their days as second-class citizens are numbered.

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