acuiti management intelligence

Crypto Derivatives Management Insight Report

Q3 2022

Introduction

Welcome to Acuiti's Q3 Crypto Derivatives Management Insight Report. This is our second quarterly insight into the cryptocurrency derivatives market, which is at a pivotal moment in its development.

The report is based on the views of the Acuiti Crypto Derivatives Expert Network, a group of senior executives from across the globe from hedge funds, banks, brokers, prop traders, asset managers and exchanges. Members of the network have also suggested the questions and topics to cover in this report. The survey was conducted from 30 June to 19 July.

In this report, we cover the impact of the dramatic recent price falls. We also asked for views on regulation and what effect it will have on market structure, as well as how market structure will be moulded by recent events.

As with our first report, we have included a Q&A. This time, we caught up with Duncan Trenholme, co-head of Digital Assets at TP ICAP. We discussed Duncan's views on the fallout from recent events and how he sees institutional participation developing from here.

This report seeks to provide a quantitative and qualitative snapshot of sentiment in the institutional crypto derivatives market. Thank you to the members of the Crypto Derivatives Expert Network for their input and contribution to this report.

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Assessing the immediate fallout

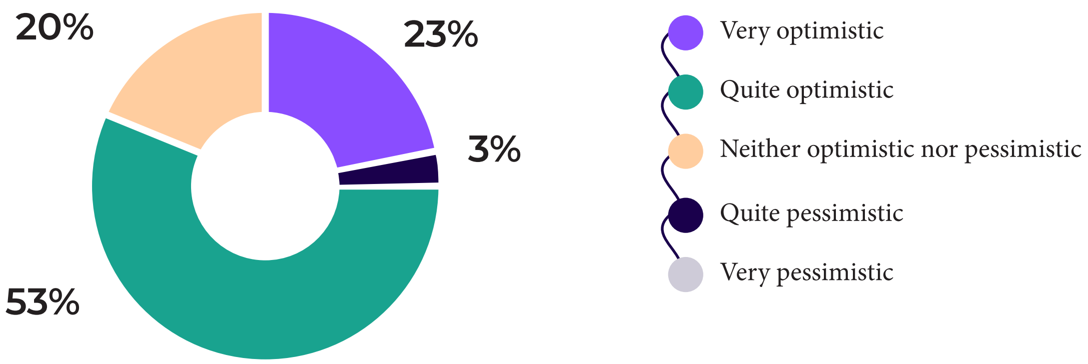
After hitting all-time highs of over $65,000 in November last year, the price of Bitcoin has tumbled to trade in a $19,000-$23,000 range since mid-June. This has wiped out about $2 trillion of retail and institutional wealth, pushed market players into default and ratcheted up scrutiny over the future regulation of cryptocurrency and DeFi.

The price falls were brutal and several high profile failures exposured weaknesses and systemic risk across the market. However, despite the recent turmoil, there is optimism that the market is undergoing a process of creative destruction rather than an existential crisis.

Members of the Acuiti Crypto Derivatives Expert Network, a group of senior professionals from across the global market that were surveyed for this report, noted that the last six months have done little to improve the asset class's reputation among sceptics.

However, most viewed the price declines as a painful but necessary step in the market's evolution towards greater credibility. Weaker firms were exposed and processes and protocols tested with some found wanting. As a result, over three-quarters of the Expert Network were optimistic about the coming quarter.

Overall, how optimistic or pessimistic are you for the performance of your business over the next three months?

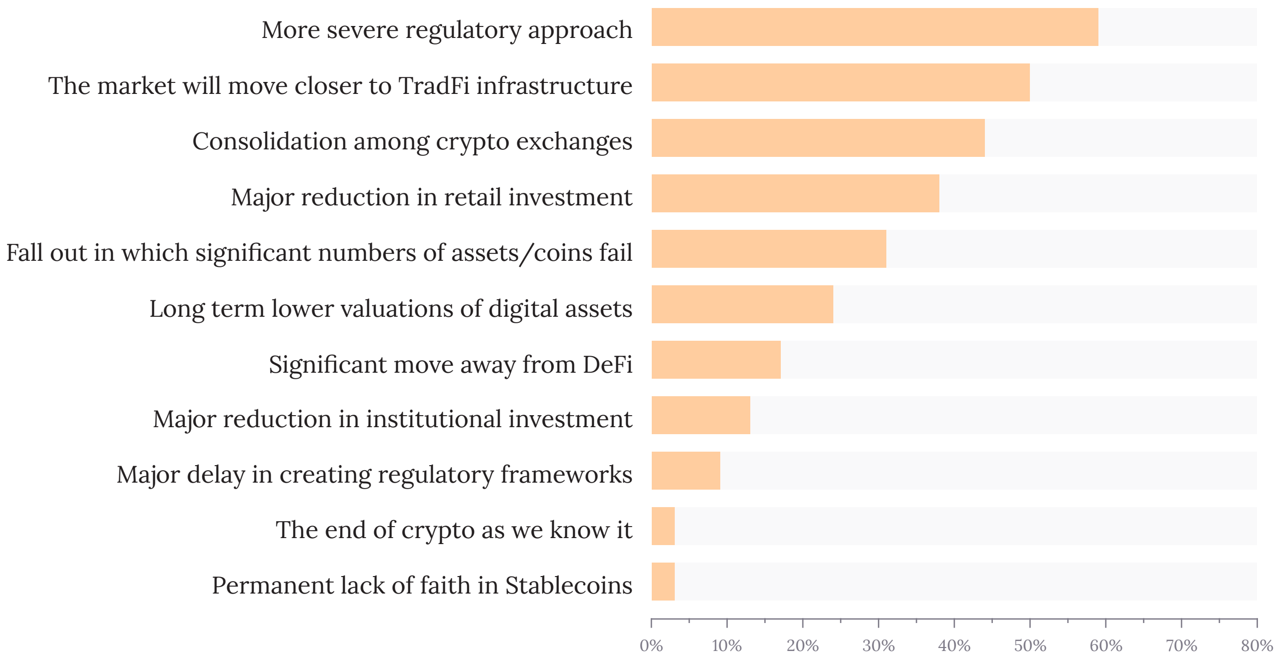


The network's majority opinion is that the current pain will also serve as a cleanout that sets that stage for more sustainable and robust future bull markets. However, most respondents are bracing for change as a result of the experience of the market in the first half of 2022.

Almost two thirds of the Expert Network expect a more severe regulatory approach will follow with around half thinking that the market will move closer to TradFi infrastructure as a result of risk management and market structure weaknesses exposed during Q1 and Q2 2022.

Another expected impact from the falls in crypto prices is a major reduction in retail investment. However, only 13% thought that the price declines would

What do you think will be the biggest medium to long-term impacts of the recent falls in crypto prices?

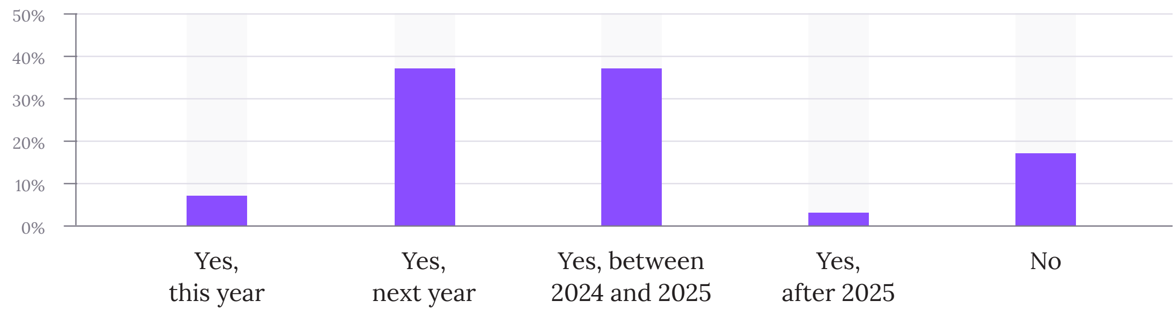


> "A shakeout is a good thing for all markets. Weak firms fall away and poorly run projects don't survive. The solid participants and those that fully see the benefits of digital assets will remain and will work closely with regulators and traditional firms to ensure longevity"
>
> Native hedge fund

result in a major reduction in institutional investment. One representative opinion was that the failure of poor and over-leveraged business models will ultimately leave a more committed and sustainable market.

Ultimately, there remains confidence that the experience of the first six months of 2022 has not knocked the adoption of digital assets in the institutional market off course significantly. This is a finding that is backed up by the Q3 Acuiti Proprietary

Will BTC go back above $65,000?



Trading Management Insight Report, which found that firms were accelerating plans to enter the market as a result of recent volatility.

This long-term confidence helps explain the Acuiti Network's optimism that Bitcoin's price will ultimately rally to new highs. Only 17% thought BTC would not rise back above $65,000 in the future suggesting significant faith in the flagship currency.

Opinion differed much more on how long that ascent will take. Only 7% thought Bitcoin would rally that high this year. Majority opinion was evenly split on whether it would do so next year or between 2024 and 2025.

As one member of the Network put it, the current trading range will either prove to be a floor to catapult from or the setting of a longer-term value (they expected it to be the former).

This bullish outlook is backed by 58% of the Network reporting increases in their exposures to Bitcoin and Ethereum and only 18% reducing it. Confidence was lower in Alt-coins, with 25% reducing exposure to these assets and just 15% increasing it.

Among those reducing their exposure to BTC and ETH, the majority (60%) said they would only do so for a month or two, while the remainder said they expected exposures to return to previous levels within the next 12 months.

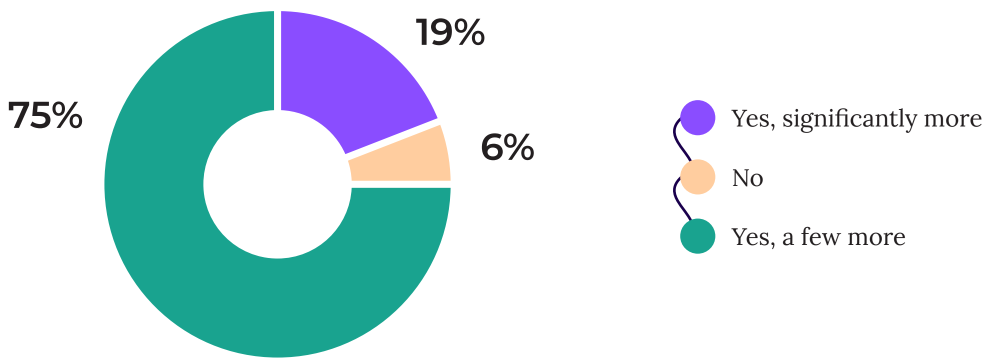
"Although crypto has crashed, the underlying technology will find it's use and some coins either existing or yet to be created, will be amazing investments"

Native prop firm

The greater bearishness on Alt-coins aligns with the thesis that the crypto winter will clear out some of the market's weaker and more obscure corners. For the cryptocurrencies that remain, this could also provide more complete track records and comparable data that allow institutional investors to evaluate investment decisions.

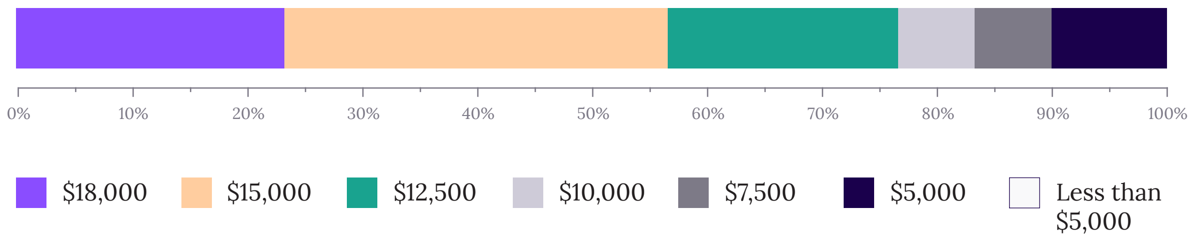
It's important to reiterate that more pain is expected before any bull market, though. Only 6% of the network believed that the default cycle among native crypto firms was over. The majority (75%) thought that there would be a few more major failures and defaults while 19% think the number will be significantly higher.

Do you think that there will be more major defaults and failures of native crypto firms?



More price drops are also a clear possibility. A third of the network think that Bitcoin will go as low as $15,000 and more think it will fall lower (NB: the survey was completed on July 19 - before the recovery in prices in early August).

What do you think will be the lowest point BTC reaches this year?

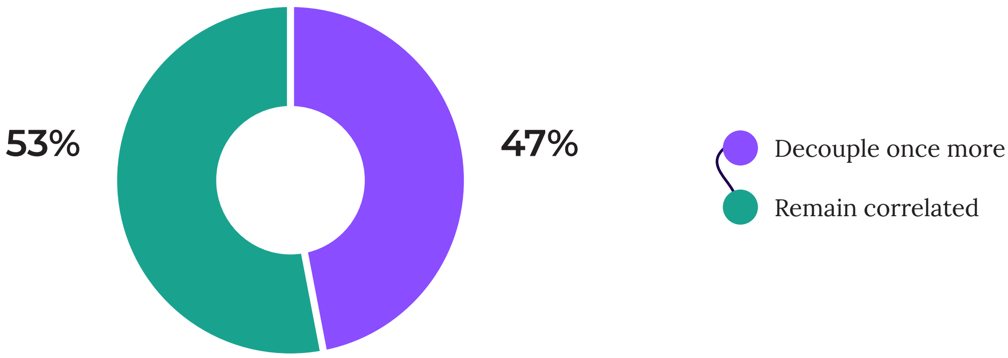


While the network was confident in a general recovery in BTC and other coins, the picture was less clear on how that price movement will correlate with traditional equity markets.

Prior to this crash and in the wake of the Covid-19 March 2020 sell-off, analysts had observed an increasing correlation emerging between Bitcoin and stock markets. This went against previous analysis that separated cryptocurrencies from traditional asset classes, weakened crypto's prospects as a hedge for those markets and strengthened the thesis that it is a risk asset.

The Expert Network was evenly split on where correlation between Bitcoin/ Ethereum and TradFi stock markets would go from here, with 47% saying they would decouple again and 53% saying correlation would remain.

How do you think the correlations between BTC/ETH and TradFi stock markets will change in the medium term?

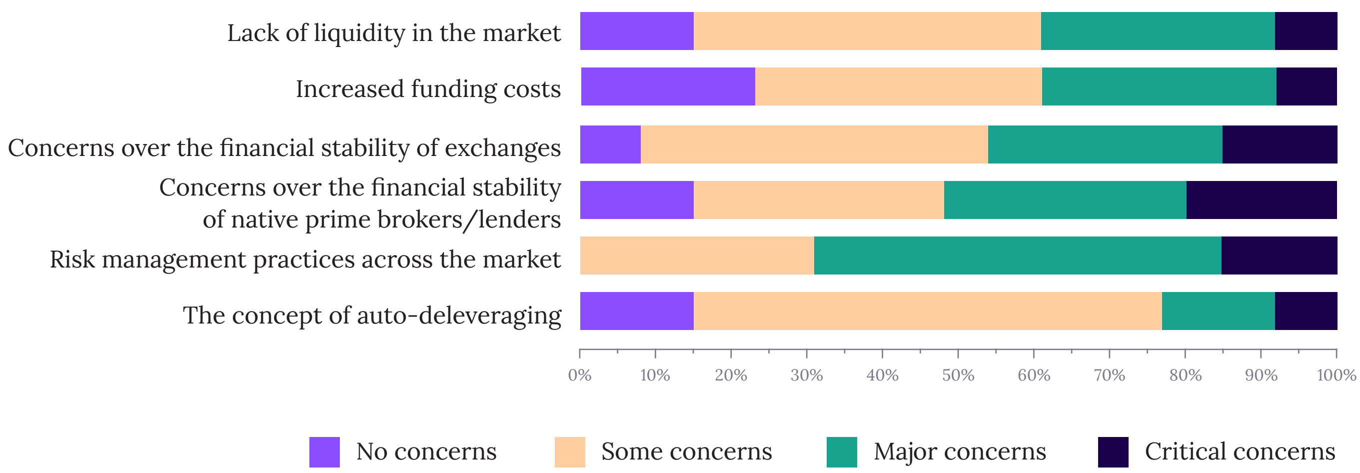


Recent market events have also raised inevitable questions about how crypto markets currently operate. The areas where the network had most critical concerns were the financial stability of lenders and native prime brokers and risk management practices.

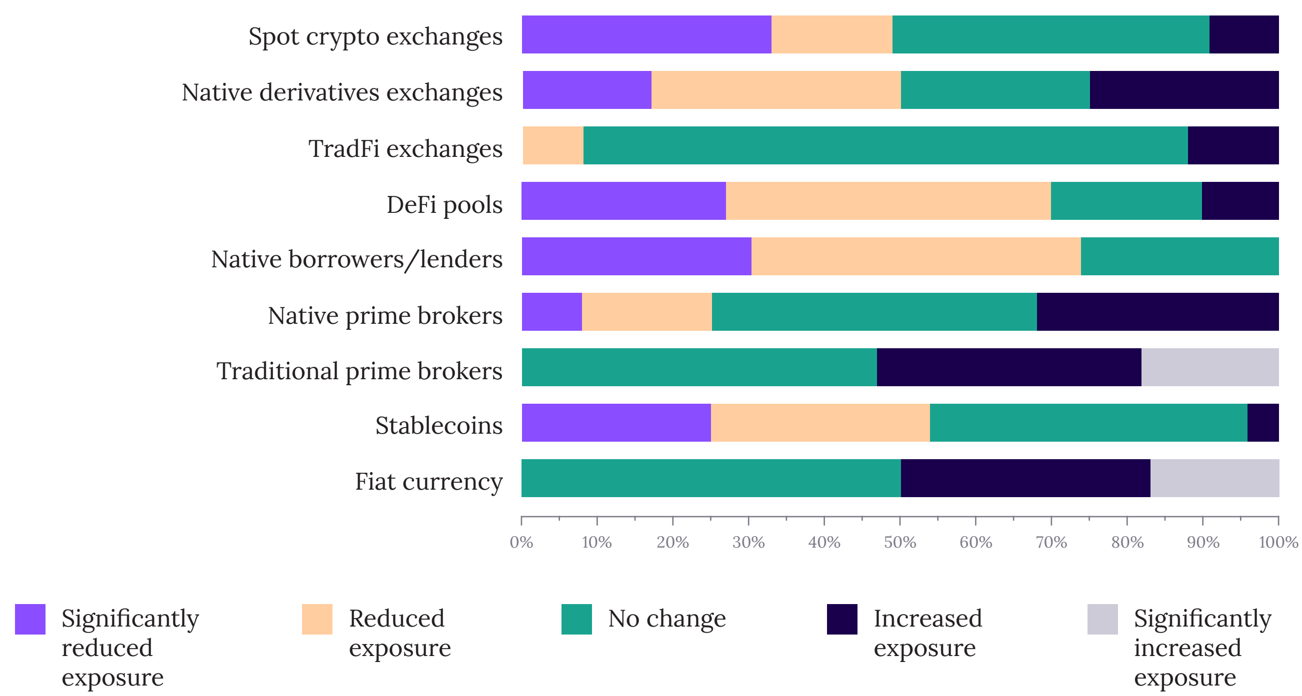
The collapse and systemic impact of 3 Arrows Capital sent shockwaves across the market and resulted in bailouts at several major firms.

Ultimately the systemic impact of the collapse of a relatively small lender across the market reflects not only the need for regulation but also the risk that emanates from the significantly lower levels of capital committed to supporting the digital assets market when compared to traditional financial markets. There is a perceptible cooling on native crypto providers in their current form, as demonstrated by the concerns about exchanges' and native brokers and lenders financial stability. This was also observable in how the network is now storing non-invested capital and excess margin (see below). However, that most firms in the market have withstood the shock is notable.

Have any of the following raised operational concerns for you and your business?



Have you changed where you store non-invested capital/excess margin as a result of recent market events?



The only venues where the network was significantly increasing exposure were traditional prime brokers (18%) and fiat currency (17%). One third reported having significantly reduced exposure on spot crypto exchanges. DeFi pools and native borrowers/lenders have also noticeably fallen out of favour (27% significant reductions each). Given the TerraLuna debacle of this year, it wasn't surprising to see most of the network reducing Stablecoin exposure to some degree (see page 12 for more detail on sentiment towards Stablecoins).

Road to regulation

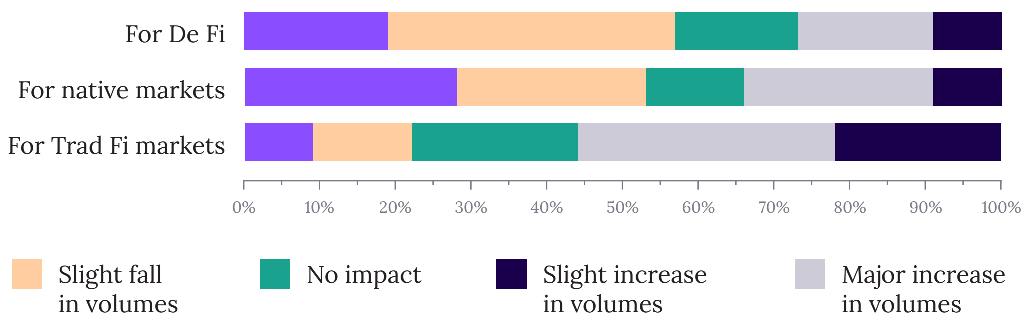
Greater regulation has long been in the pipeline for cryptocurrencies. Its arrival has largely been encouraged by market participants pitching for institutions to adopt the asset class.

As noted earlier, the Expert Network expects that a tougher regulatory approach from authorities will be a lasting result of recent falls in crypto prices. This is already playing out to some extent. In its pursual of an insider trading case against a former Coinbase manager, the SEC has signalled that it considers at least nine Cryptoassets to be securities. The EU's MiCA framework is making its way towards formal approval.

Ultimately, the network expects greater regulation to favour TradFi. A minority of the network saw regulation accruing the same benefits to native and DeFI markets. Most saw volumes falling to some degree on these platforms.

While regulation is largely seen as necessary for growing the institutional crypto derivatives market, the network still harbours trepidation about how optimal finalised frameworks will be for market growth. The EU is seen as the most likely major jurisdiction to be the first to develop a framework that will enable significant institutional participation.

What impact do you think that increased regulatory oversight will have on trading volumes for De Fi, native exchanges and Trad Fi markets?



Singapore, the US and UK were seen as likely to follow close behind it. However, only 10% of respondents thought that the EU would create the best regulatory environment for institutional adoption of digital assets. In this respect, the US was seen as the most promising regulatory regime backed by 35% of respondents. The UK (23%) and Singapore (19%) were also seen to have potential to develop a robust framework for greater and long-term institutional participation in digital assets.

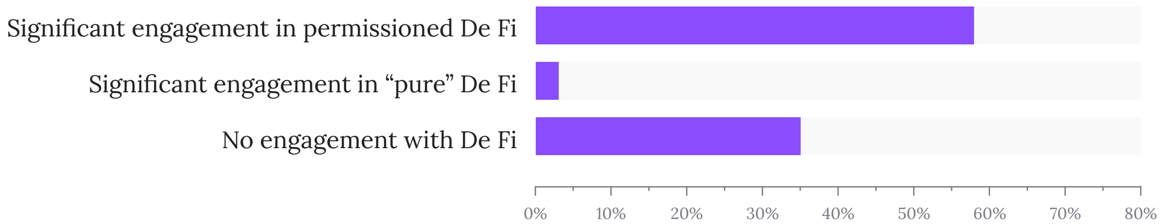
Engagement with DeFi and exchange competition

Beyond price movement, the recent market turbulence is set to bring in structural changes – both through the exit of some market participants and through changing attitudes to practices like risk management and leverage. In the medium-term regulation will level the playing field for traditional and native firms.

One route for this to happen is consolidation, a trend that was already observable in the market's most recent bull phase. The Network strongly expects that crypto exchanges will now consolidate further. The Network also expects that competition for market share will increase. An overwhelming majority of the network (79%) believe that a new entrant exchange in crypto options could build significant market share against current incumbent Deribit, for example.

The Network also believes that banks will come to play a strong role in DeFi, with 58% believing they would play a significant role in permissioned DeFi (only 3% thought this would happen in pure DeFI though). However, a sizeable proportion (35%) still thought that banks would have no engagement with DeFi in the future.

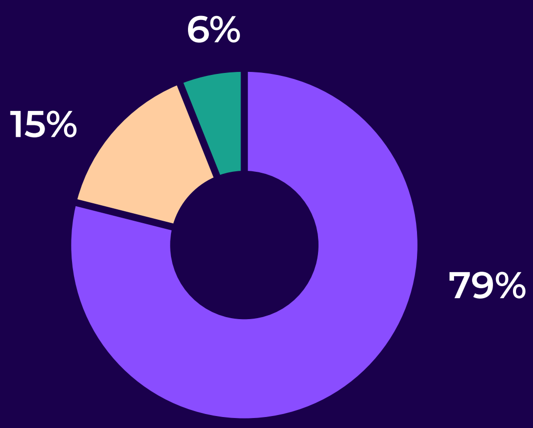
What role do you think banks will play in the future of DeFi?



The future of Stablecoins

Of all the corners of crypto markets, few have attracted more scrutiny than Stablecoins in recent months. The high-profile collapse of TerraUSD triggered chaos in the market. Despite that, only 3% said that recent events would lead to a permanent lack of faith in Stablecoins (see page 5). Just 15% saw central bank digital currencies eventually replacing stablecoins in crypto market structure. However, only 6% thought that algorithmic stablecoins, such as TerraUSD, had a future. The overwhelming majority of the network (79%) said that only "fully backed Stablecoins" will survive.

What do you think is the future of Stablecoins?



- Only those "fully" backed will survive
- CBDCs will replace all stable coins
- Algorithmic stable coins will re-emerge

Q&A with Duncan Trenholme,

Co-Head of Digital Assets, TP ICAP

Duncan Trenholme is Co-Head of Digital Assets at TP ICAP. He has co-led the interdealer broker's drive into the Cryptoasset class, beginning with CME Bitcoin futures and options and expanding to other derivatives since, including Ether derivatives.

He is currently working on an upcoming wholesale spot exchange. The firm is pending its FCA AML/CTF registration but plans to launch a spot exchange where trades will settle through segregated custodians, with the first being Fidelity Digital Assets. Here, we discussed his take on the recent crypto winter, what it means for crypto derivatives and how it will affect institutional appetite for the asset class.

How has the last quarter been for your crypto derivatives business and what do you feel the first effects of the crypto winter have been on the market?

Our volumes have grown quite significantly in the last three months. Whilst some of that is a result of the market downturn, and a resultant flight to quality, it's largely due to overall growth in new participants entering the market. The customer acquisition lifecycle within this asset class is long- there is a lengthy approval process, due diligence process, and implementation process for large financial institutions. As an example, we recently executed our first trade with an investment bank, which has been two and a half years in the making. As such, our success in the last quarter is mainly due to the work we've been doing since we launched this business in January 2020 and getting to market with some new clients.

But I would also say that because of the recent defaults and bankruptcies in the crypto market, there has been a renewed focus on risk management from clients already active in the asset class. The result of this is that who you are dealing against, and which venues you are executing on, becomes increasingly important. We've certainly benefited from this based on being the world's largest interdealer broker. This has certainly been one of the initial effects of the financial crisis that gripped the asset class and pulled us down into the start of this "crypto winter".

We've tried to be consistent throughout the establishment of our Digital Assets business in saying that there are some aspects of traditional finance, like a segregation of roles and responsibilities, that are really important for the market and were, in our view, largely missing in crypto markets to date.

Many firms were engaging in proprietary trading and lending, often whilst holding customer funds and reportedly sometimes with customer funds. It's caused real problems, and hopefully the market can emerge stronger by addressing these structural issues moving forward.

In the crypto derivatives market, most of the flow has historically gone through major crypto native exchanges or between crypto trading firms through OTC bilateral derivatives. Many of the crypto derivatives exchanges are domiciled in non-traditional financial jurisdictions and many of the crypto firms are new entities or organisations not previously onboarded at financial institutions.

As such we've seen that our traditional clients entering this market have largely been focusing on regulated venues, such as the CME. These are the only places, for now, that many firms have approval for or were comfortable dealing on. This has resulted in a bifurcated market, with more regulated actors separated from the venues that firms that are crypto native or have more risk appetite are trading on.

Off the back of the recent market volatility, we've seen more willingness from firms that previously would have shied away from the regulated venues, such as the CME, to execute there. I would imagine it's due to a shift in risk appetite - a flight to quality.

Will this strengthen institutional investors' preference for TradFi over native exchanges in the long term then?

That's hard to say, but we'll learn a lot in the next six months. The majority of firms from our existing client base that have entered this market to date have been primarily focused on the regulated venues that offer Cryptoasset derivatives. That's in part from a risk management perspective and in part due to the familiarity with these venues, both operationally and technically, and due to existing connectivity into internal systems being in place.

We're watching whether, as more TradFi firms come to the market, that demand continues to build on the regulated venues and existing crypto liquidity continues to migrate across to these venues. Or whether the crypto derivatives exchanges are able to get licenses to operate in more traditional financial jurisdictions and are able to be onboarded by financial institutions. It remains to be seen how this plays out.

One thing that is also worth mentioning is that the massive drawdowns in crypto prices, and the resulting defaults among financial firms, has only accelerated the pace of regulators bringing in rules for the market. It's no surprise that there has been a string of announcements of Cryptoasset derivative exchanges seeking regulatory licenses – or buying smaller traditional derivative exchanges with their existing licenses.

For now, are institutional traders more likely to favour OTC? How is that market developing?

I think institutional traders will favour a mix of OTC derivatives versus other ISDA members and listed products on derivatives exchanges with the right regulatory licenses. Preferences will likely vary depending on the profile of their organisation and their biases from their previous or existing asset class and how it tends to trade.

The OTC Cryptoasset derivatives market is beginning to expand beyond the current crypto native firms who have relationships with each other. The current market evolved over the last few years by firms setting up bilateral long form confirmations with each other – a process with limited standardisation and not using ISDA documentation. In general, a lengthy process.

For the TradFi firms now coming to the market, trading swaps, OTC options and NDFs against other ISDA members is something they are often very familiar with across traditional asset classes. However, to strike an OTC derivative with a crypto firm requires setting up a new customer relationship. It's no surprise that over the least year we've seen a lot of these firms registering for ISDA membership. That will accelerate setting up trading relationships with TradFi institutions.

In the short term it's also likely to be a bifurcated market with some of the investment banks that enter crypto trading OTC derivatives with each other. And then that pool of crypto firms also dealing with each other. I think those markets are going to evolve slightly separately and then gradually connect as bilateral relationships between the two markets are setup.

You mentioned the likelihood of accelerating regulation, how is this affecting market sentiment?

From our perspective it's very healthy as it will bring more confidence in the markets and increase investor appetite. I think there is now a level of acceptance in the market that this is something that's necessary for the next stage of evolution of the asset class.

It's worth noting that the regulatory noise around crypto is mostly focused on the spot asset, where there is still considerable uncertainty. For example, in the US we are not sure if, beyond Bitcoin, these assets are securities or commodities, or something different? Or, for example, in Europe the assets are not considered MiFid instruments and are outside the scope of regulation until MiCA comes into effect.

But for crypto derivatives, by in large it is clear that they're already regulated because derivatives fall within existing regulatory perimeters. For example, in the UK we see Cryptoasset derivatives as specified investments, therefore, they are required to trade on OTFs or an MTF. Likewise, if you were to set up an OTC derivative in the US, like a non-deliverable forward or OTC option, it's going to get booked on a SEF.

It's therefore important to separate the regulation of the spot asset from the derivatives products. The first we're still waiting on clarity for, the second largely fits within existing frameworks.

It's been great to see regulators working with industry and being proactive. As these frameworks start to fall into place for the spot assets, that will really bring in a wave of traditional financial firms. The regulatory ambiguity is definitely an impediment for them to enter this asset class currently.

Will recent events narrow the pool of underlying cryptocurrencies that derivatives are traded on?

I think it reinforces the strategy of many traditional financial institutions to start small with the number of assets and expand slowly. Many of the top Cryptoassets are very new, unproven, and with huge regulatory uncertainty. We were reminded during of this fact this last market downturn with a major token in the top 10, Terra Luna, having well publicised issues and effectively trading to zero.

Whilst I don't think it will narrow the pool that derivatives are traded on, I think it will continue to increase focus on performing due diligence of the assets ahead of providing services in them. Plus, the pace of innovation in the asset class is so great, that a top 10 of the tokens in 2019 looks very different to a top 10 in 2022. You can say with a large degree of confidence that Bitcoin, and Ethereum, are now established and here to stay, but beyond that it's harder to draw conclusions at this stage.

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