Crypto Derivatives Managers' Insight Report

Q2 2022

Introduction

Welcome to the inaugural Acuiti Cryptocurrency Derivatives Management Insight Report. This is the first of a quarterly series of reports delving into the attitudes and approaches of senior executives in the cryptocurrency derivatives markets.

Survey data in this report is sourced from members of Acuiti's Crypto Derivatives Expert Network, a group of senior executives at prop trading firms, hedge funds, banks, brokers and exchanges. The purpose of this report is to identify challenges and promising opportunities that participants see in this still nascent market.

Key themes that the network identified in this report are getting regulation right for growing the market, boosting traditional sell-side intermediation and how market structure will evolve.

In addition, this report contains an exclusive Q&A with Jad Comair, founder and president of Melanion Capital, which launched the Melanion BTC Equities Universe UCITS ETF last year.

The Acuiti network is interactive and members can submit topics and questions on the market that they want to pose to their peers. Please get in touch if you are not already a member of the network but would like to join.

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Market Structure

In this report, we focus on market structure, the evolution of the exchange environment and ask how the traditional derivatives market will evolve alongside the innovations native to cryto.

The market for crypto derivatives has grown rapidly in recent years. Since Binance, the largest futures exchange today, was founded in July 2017, the overall futures market has grown to a peak of $4.96tr in 2021.

That has happened alongside a growing market share relative to spot, with derivatives markets accounting for 62.7% of all crypto trading in February[1].

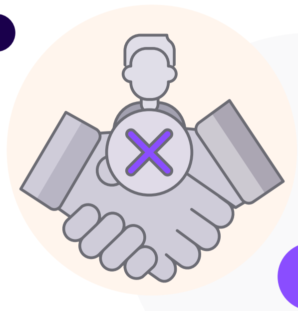
Binance accounts for most activity in the futures market, with 47.6% of total volumes. In February, the exchange recorded average daily volumes of $600bn in Bitcoin futures while OKex saw ADV of $200bn, Bybit $140bn and FTX $119bn[2].

Deribit currently dominates flow in Bitcoin options with 90% of total volumes, hosting $16.3bn of volumes in February while Okex saw $475.4m and Binance $27.1m.

CME Bitcoin futures and options – products better recognised in the institutional investor community – accounted for $36bn and $362.8m of volume respectively.

The dominance of native crypto derivatives markets comes despite the uncertain regulatory regime they operate in. This is resulting in the growth of a bifurcated market between traditional and native financial institutions.

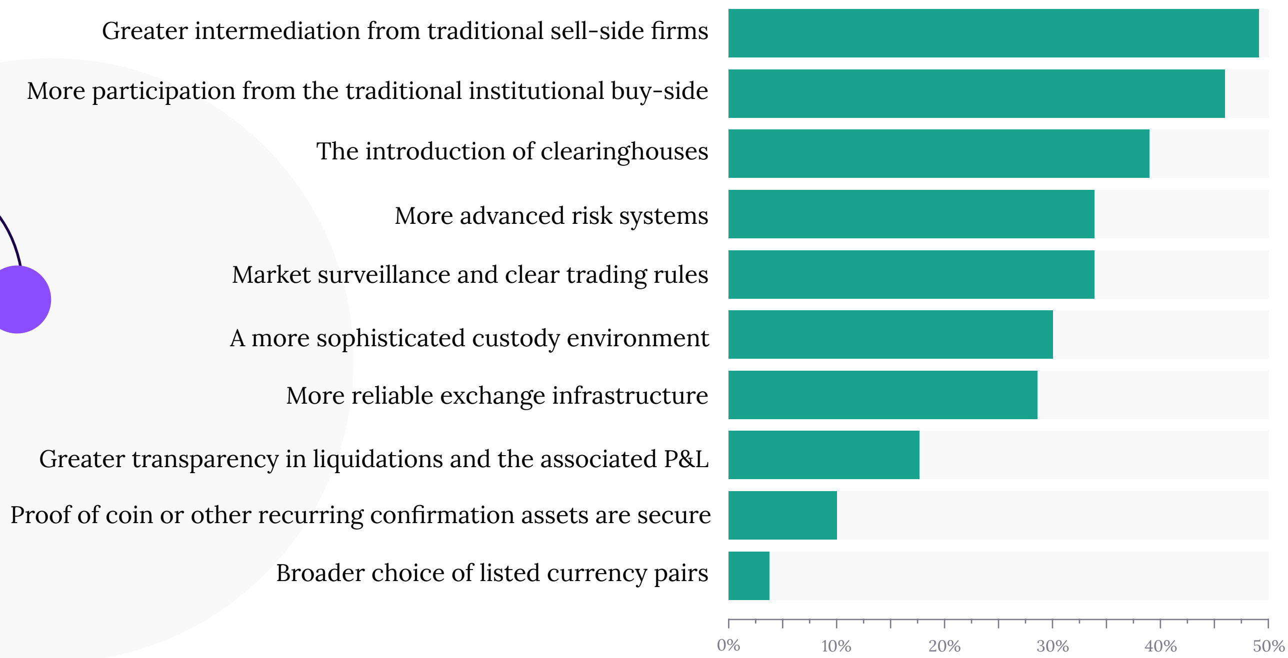
Sell-side disintermediation?



Members of the Acuiti Crypto Derivatives Expert Network identified greater intermediation from traditional sell-side firms as the factor that could have the biggest positive non-regulatory impact on the environment for trading crypto derivatives (see chart on next page).

[1] CryptoCompare, Exchange Review, February 2022 (Source)
[2] Source

Apart from regulation, which of the below would have the biggest positive impact on the environment for trading crypto derivatives?



To the same end, a greater traditional buy-side presence was the second factor that Network believes will have the biggest impact on growth. This is a fast growing market and 80% of Expert Network members that provide services to traditional institutions reported fast growing demand from buy-side participants for trading in crypto.

Some sell-side firms such as Goldman Sachs and TP ICAP have made forays into crypto derivatives, providing liquidity in ETC Group Physical Bitcoin and CME Bitcoin Futures. Last month Goldmans conducted the first OTC non-deliverable option trade by a US bank with Galaxy Digital Holdings. However, most other traditional sell-side firms have been hesitant to enter the market outside offering clients clearing for derivatives on CME.

In place of traditional sell-side firms, a host of new, native crypto sell-side providers have emerged to offer access and services to crypto derivatives markets. As in the exchange world, this poses a challenge to traditional financial infrastructure.

Perhaps the most interesting development in this respect comes from FTX, which has applied to the CFTC to operate a regulated 24/7 derivatives markets offering a range of traditional products in addition to crypto with a market structure that effectively disintermediates the role of the traditional clearing member.

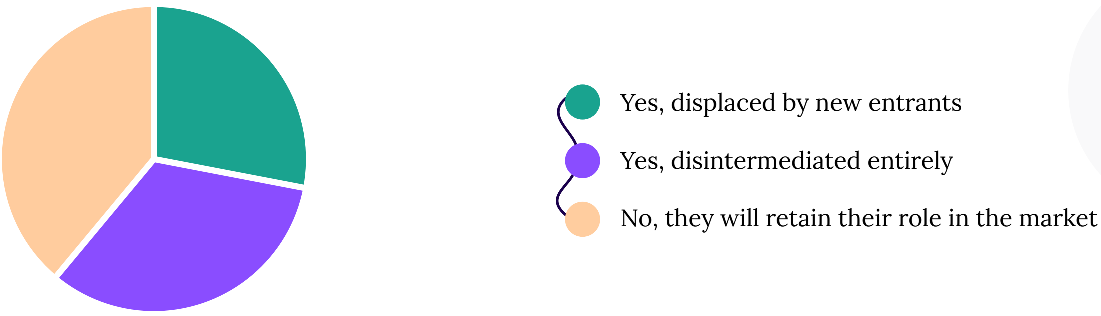
The CFTC has launched a consultation on the proposals and, while it is not expected to approve the market to trade in traditional futures and options any time soon, it is likely to approve it for crypto derivatives as a test case. This represents one of the most significant potential innovations in derivatives market structure since the advent of electronic trading.

Crucially it is also a tantalising glimpse of how innovations in the native crypto market will fundamentally change market structure beyond bitcoin and digital assets.

Which coins would you like to see derivatives listed on?

1. Solana (SOL)
2. Tether (USDT)
3. USD Coin (USDC)
4. Polkadot (DOT)
5. Cardano (ADA)

Do you think that the traditional sell-side could be displaced by new entrants or disintermediated entirely in crypto derivatives?

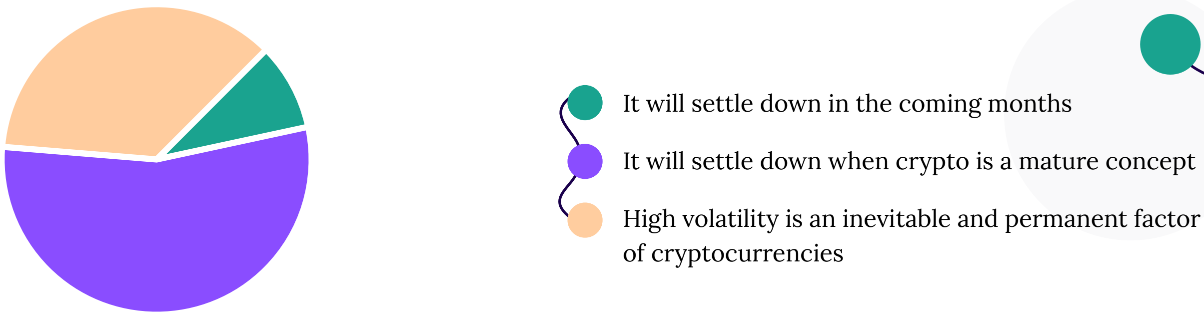


The question ultimately is what impact this will have on the traditional sell-side. While over a third of the Acuiti Crypto Derivatives Expert Network thought that traditional sell-side firms would retain a role in the market when established, nearly two-thirds thought that they would be displaced by new entrants or disintermediated entirely. Without adequate regulation to give the sell-side the opportunity to develop services, this remains a major risk for these firms.

Market evolution

More than two thirds of the Expert Network think that crypto will become a less volatile asset class as the market matures. If current proponents' efforts to educate and bring more institutional liquidity and pricing methodologies into the markets succeed this could stabilise the market. But given many market participants are attracted to the volatility in crypto, a reduction in volatility will also pose challenges to digital assets.

How do you see the high volatility environment of crypto evolving?



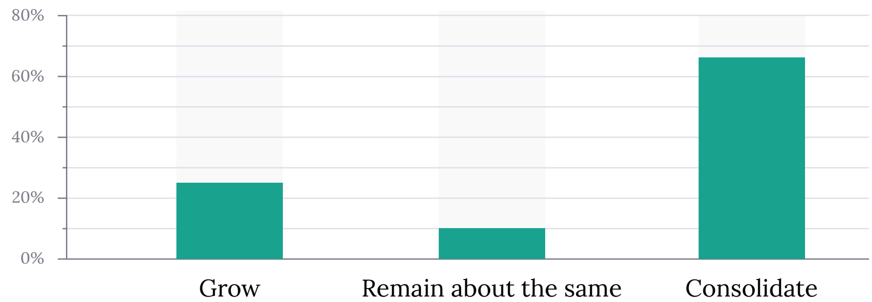
While not as fragmented as the spot crypto market where hundreds of exchanges compete, the crypto derivatives market remains splintered. Currently there are around 8 derivatives markets with notable liquidity in futures, options or perpetual contracts.

The market has also grown bifurcated between the native crypto market and the traditional markets. The latter have experienced difficulties in making an impact with CME the only major traditional financial exchange to boast any significant liquidity today.

That is likely to change as exchanges launch new and innovative products such as ETFs and perpetual futures. However, the native market remains well ahead in terms of derivatives liquidity despite the disadvantage of not being the incumbent or being able to operate in an established regulatory environment.

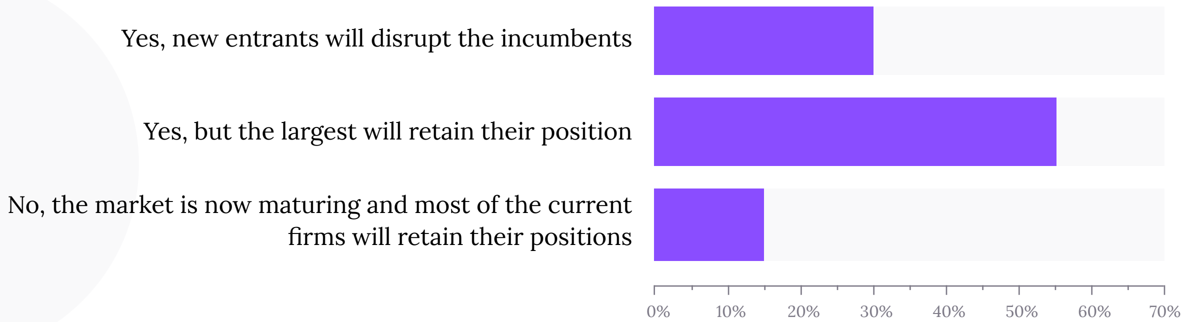
The barriers between the native and traditional markets are beginning to blur, however, following several deals including Coinbase and FTX both buying traditional, regulated markets in the US.

Do you think that the number of crypto derivatives exchanges will continue to grow or consolidate over the next five years?



Members of the network expected a consolidation of the number of crypto derivatives exchanges and mostly saw it as a positive for the market – although some warned of emerging monopolies. Some thought that there would be a significant change in the hierarchy of crypto derivatives exchanges over the next three years, although most respondents thought the largest players would retain their position. However, 29% thought that new entrants would disrupt the incumbents.

Do you think that there will be a significant change in the hierarchy (i.e. those with the most volume) of current crypto derivatives exchanges in the next three years?

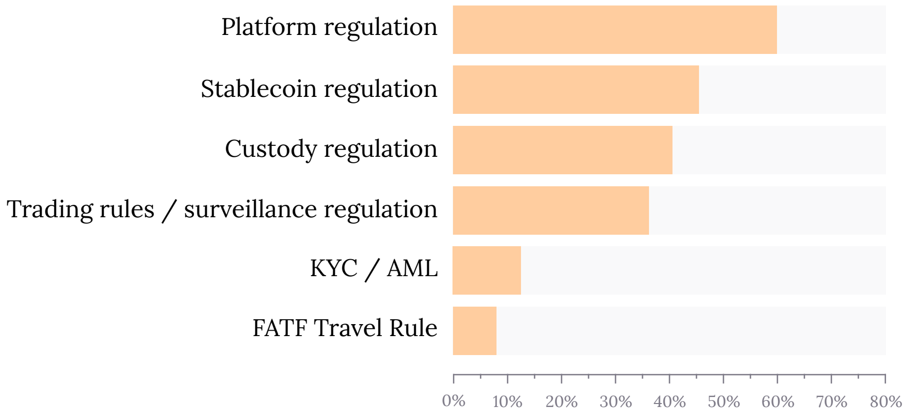


As the market matures exchanges are looking to grow through offering more services to the market. One ongoing debate revolves around whether exchanges should be licenced to offer custody services to institutional clients. FTX argued strongly in favour of this in a recent paper. Views of the expert network are fairly split on whether they should also be licenced as custodians, with 60% saying that they should not, citing concerns of security and a market dominance. Prop traders were the market participants most likely to back exchanges taking on custody responsibilities, while brokers were most opposed to the idea.

Regulatory infrastructure

Institutional market participants are fairly unanimous in calling for a better regulatory framework for crypto and crypto derivatives markets - so long as it is done correctly. The long-standing hope is that clearly defined and constructed frameworks will attract better and more robust liquidity into the market. This would enable greater engagement from traditional buy and sell-side firms.

In terms of regulation, what is missing or needs development in the ecosystem for trading crypto derivatives?



There are multiple fronts on which the market can be regulated. Members of the network saw platform regulation as the priority area for regulation but stablecoin and custody also ranked highly.

Trading rules and surveillance, including reporting violations to authorities, were also seen as priority areas for greater oversight. Many traditional firms are still wary of the reputational risks of crypto, given headlines around money laundering and fraud in these markets.

While regulation is a key concern in the market, there are still also technical issues that crypto derivatives need to overcome. Auto close out of positions was as by far and away the most major challenge cited in this respect.

Top challenges for firms trading crypto derivatives :

1. Auto close out of positions
2. Latency of venues
3. Exchange fees
4. Uptime of venues
5. Absence of a CCP
6. Custody arrangements
7. Exchange market data fees

How are firms trading crypto derivatives markets?

Plurality is a strong feature of crypto derivatives markets. This applies to venues and products, with high levels of fragmentation in the former, compared to non-crypto asset classes. Almost all trading firms in the Acuiti network had access to multiple crypto exchanges for their derivatives trading and two thirds traded on six or more venues.

Diversity is even stronger in coins, with over 80% of firms trading spot in more than 11 coins as part of their core strategies.

As the market for derivatives evolves, more coin pairs will be offered. There is also a growing market for structured products. While supply is still limited, their trajectory for growth will surely only strengthen as market participants look to better tailor their pay-offs.

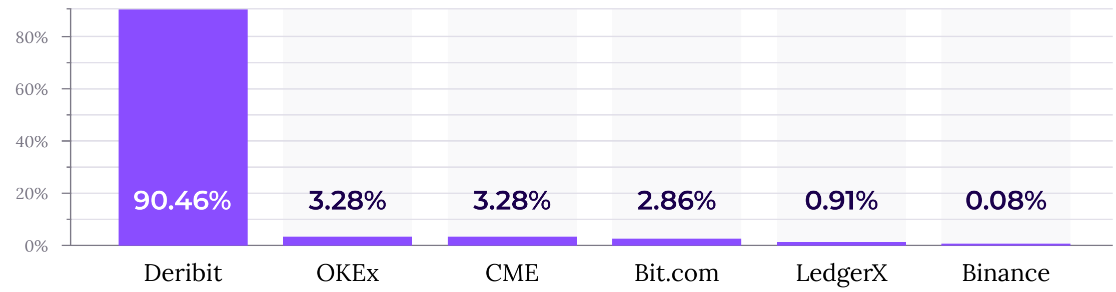
Respondents showed a preference for options over futures saying they had the best risk vs reward payoff and greater diversification benefits.

Members of the network saw the biggest opportunity for arbitrage in trading derivatives between different underlying coins over and above spot and derivatives or trading across exchanges.

Around a third of respondents were trading crypto derivatives on DeFi platforms. This represents a substantial increase on the 15% that said they were trading on DeFi platforms when Acuiti last conducted a survey on crypto derivatives in Q1 2021.

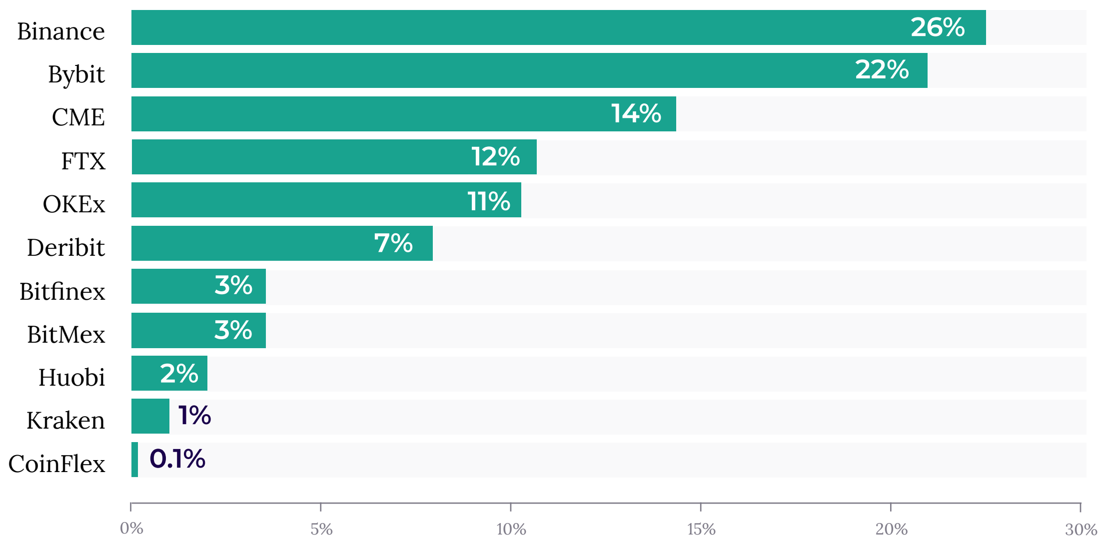
Derivatives market share

Options volume market share (BTC)*



Source: Skew

Futures open interest market share (BTC)**



Source: Skew

*As of end of March 2022
**As of April 8 2022

DVOL: How does BTC volatility trade?

DVOL is a measure of BTC volatility calculated using Deribit's options order book to provide an implied volatility for Bitcoin.

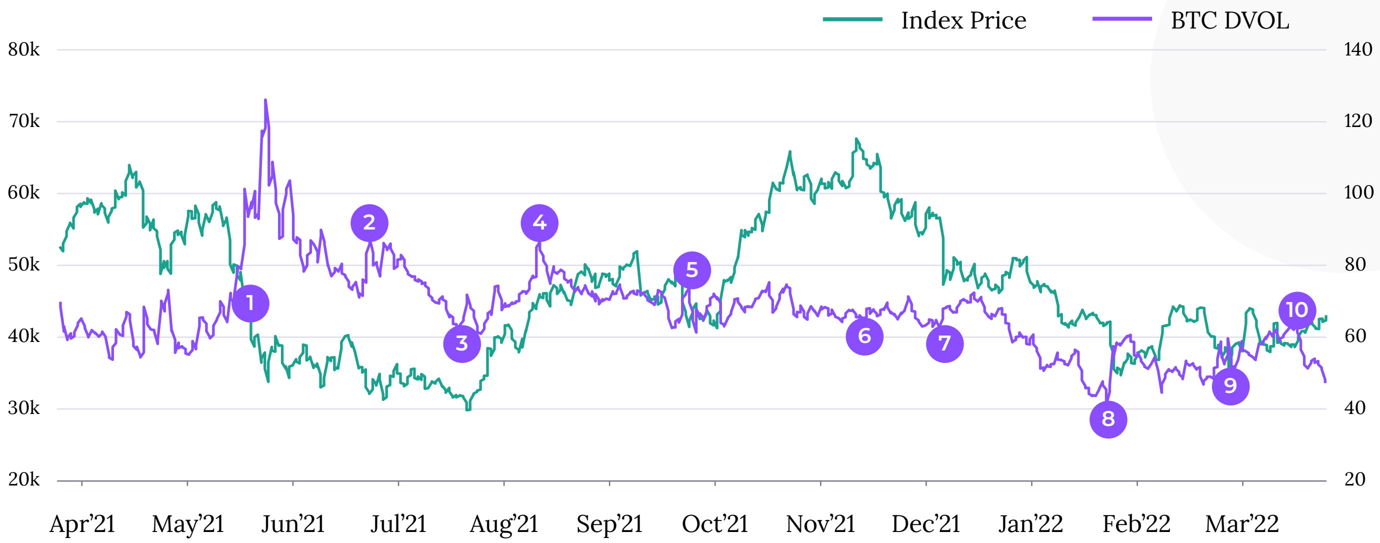
The chart below shows the DVOL level vs the index price for BTC over the past 12 months. Two points are particularly notable. Firstly, volatility in BTC is moved more by market news about BTC rather than world events.

The second, is how DVOL is uncorrelated to VIX. While the VIX, and equity volatility generally, spiked sharply around the Russia invasion of Ukraine, DVOL increased only marginally. In addition, while the VIX moved up when the Fed increased rates last month, DVOL fell. This trend suggests the potential for an interesting trade for volatility traders trading DVOL against the VIX.

One trend to watch when trading DVOL is the impact of the growth in adoption of DeFi Options Vaults (DOV). DOVs, such as Thetanuts, allow users to stake some assets to a decentralized vault, which generates a yield from selling the options premium.

The growth in the adoption of DOV is increasing the organic retail flow selling options, which are then hedged by institutions on platforms like Deribit. As these DOVs get more popular, it results in lower volatility and can result in lower implied volatilities despite rising realised volatilities.

DVOL: The Bitcoin Volatility Index



1. Large spike in DVOL as price crash in response to China banning crypto mining
2. China orders shutdown of crypto mining operations in Sichuan province, one of the biggest bitcoin mining centers in China
3. Rumours of Amazon accepting crypto payments with job posting. Jack Dorsey and Elon Musk are among prominent speakers to take the stage sharing optimism on Bitcoin
4. Bitcoin price rebounds and volatility spikes as US Senate continues debate regarding the cryptocurrency tax provision
5. SEC approves the first bitcoin futures ETF
6. Bitcoin falls in price from its all time high while volatility remarkably stays around 80, as Fed Reserve scale back quanititative easing. Also taproot upgrade goes through without issues
7. Bitcoin sharp drop follows plunge in tech stocks as concerns of Omicron spread
8. Fed signals upcoming rate hikes
9. Russia invades Ukraine
10. Fed raises rates for first time since 2018

Interview

Crypto Derivatives: the state of play with Jad Comair, president of Melanion Capital

Jad Comair is president of Melanion Capital, which launched its first Bitcoin thematic ETF last year. The firm has also created a SPAC, Melanion Digital, that will invest in green and clean Bitcoin projects. Here, Jad discusses the crypto derivatives landscape and how regulation can be designed to help the market prosper.

What is the state of play in crypto derivatives markets at the moment?

Unlike the cryptocurrency markets, most of the trading in crypto derivatives has been historically done offshore. Whether options, futures or perpetual swaps, it is the offshore exchanges that have biggest market share. This is because they don't have the onshore regulatory constraints and could therefore allow retail investors to get leverage on crypto. They now have the biggest market share and the tightest spreads as they have the highest volumes. But we are now seeing more and more offshore players trying to come back onshore because of regulatory pressure.

Regulators around the world differ a lot. They can go as far as pursue market participants for illegal activity like in the USA, or blacklist and label as non-recommended as European and some other authorities do.

There is a lot of hype and uncertainty around how this ecosphere will develop and as a result we are seeing more unregulated exchanges looking to become regulated.

How are the onshore and offshore markets developing?

Derivatives are considered financial instruments in most onshore jurisdictions. That means needing the whole wholescale traditional set up and existing licences to be able to offer financial products. This is how CME Group was able to issue Bitcoin futures and options – as a well-established and regulated exchange they had all the parts in place.

So there are very few new players coming into the onshore derivatives market, as it is very heavily regulated.

We have seen some new players trying to do onshore but most activity is through crypto itself rather than the derivatives because they have completely different regulatory treatment to crypto the underlying.

In France, to offer custody and trading solutions on crypto you need to have licence requirements that are mainly declarative. These are non-binding and much lighter than if you want to offer the same service for traditional financial products, which crypto futures and options fall into. That is more or less the same situation for the developed countries in Europe and some parts of Asia.

What level of overlap do you see between participants in crypto and crypto derivatives markets?

There is definitely overlap between crypto derivatives and crypto. From a retail perspective, crypto derivatives are where the big offshore flow is. Traditional crypto is more professionalised, onshore.

In crypto derivatives, the liquidity is much more parcelled. The players are much smaller with retail and small shops active - you don't have the big names that you would see in the traditional derivatives space.

These big traditional players struggle to enter crypto derivatives.

Once the regulation evolves sufficiently, the traditional players will step in and be able to bring much more significant crypto derivatives volumes onshore.

What regulation is needed to make this happen?

First, we need to have a clearer view on all the traditional issues that are relevant in any asset class. So KYC and AML - all the stuff that you need to have the traditional actors, mainly the banks, onboard.

Regulations must evolve to allow them to offer services in these markets. The big entry barriers for banks are strict regulations and a lack of explanation on how these new products should be treated.

Our ETF is an equity ETF based on the beta correlation of equities with Bitcoin. But because Bitcoin is in the prospectus we come across a lot of closed doors. People don't want to touch it as they see Bitcoin and know there is little regulation.

There is also a generational issue. We have a lot of missed opportunities with traditional players who still think crypto will eventually go to zero and won't spend time looking at it.

Headlines about how crypto consumes energy and it used to evade sanctions don't help either. All these players pay attention to headline risk. It took years to build their reputations and they need more knowledge before they go and put their necks on the line.

But they cannot ignore the asset class either as they are losing customers to it. They are sitting between two chairs and not knowing how to approach the issue. That is why regulatory solutions are needed. After that they will be happy to step into the market.

These more traditional players will be wiped out if they don't react to this trend though. They are very good on the regulatory of the equation part but very bad on execution.

Do you see increasing consolidation among crypto derivatives exchanges?

It is tricky. Some big players want to go onshore and that can lead very quickly to them going and buying an onshore venue. But at the same time, they cannot go 100% onshore as then they can't offer the flexibility of an offshore exchange. It is very hard for them to have both.

So, I think there will be M&A for onshore venues, with newcomers buying onshore exchanges. Also, any offshore players going onshore will open an opportunity for new offshore players to go take their place.

It's a situation with a lot of changing names and constant evolution.

But it's going to stay split like that until maybe 10 years' time, when they will consolidate, and more traditional big players will enter the market.

How are derivatives products evolving? Some structured products are already being traded...

Autocallables are structured products that offer a pay-off and are very common in the traditional financial space. There are a lot of traditional products that can be structured with crypto as the underlying. With an autocallable you are able to buy a product that restrikes every year, so you are not just long crypto. And investors like the payoff as if it goes wrong one year they still have another year to recoup their losses. You still only have one or two shops offering it worldwide though. So you can buy them today but it's still very early stages.

About Acuiti

Acuiti is a management intelligence platform designed to provide senior executives with unparalleled insight into business operations and industry-wide performance. Acuiti helps identify market trends, enhance decision-making and benchmark company performance. The platform anonymises and aggregates information from its exclusive networks of senior industry figures in specific markets to provide insightful in-depth analysis. The Acuiti Crypto Derivatives Expert Network is a virtual forum of senior executives in the market. Each quarter we provide this report based on questions and responses submitted by the network. Interested in joining the network? Contact Alice Kristiansen at alicekristiansen@acuiti.io.

About Deribit

Nine out of 10 Bitcoin options traded worldwide are traded on Deribit. True to its Dutch roots, Deribit is a derivative exchange with traditional principles including a high degree of self-regulation, dedicated hardware with colocation services in Equinix LD4, Market Maker Protection enhancing the tight bid offer spreads, Block Trade & RFQ Solutions, low latency round trip times, variety of custody solutions, all of which make it trusted and preferred by some of the largest traditional market makers, buy-side and sell-side.

Pioneering Bitcoin and Ethereum options, the exchange hosts the largest choice of expiring futures on these currencies, whilst expanding to cover many Altcoin perpetuals settled in USDC and Solana futures & options. Deribit will also be launching the first tradeable Bitcoin Volatility Futures (based on our DVOL index). This effectively is the VIX for crypto.

To find out more, contact Deribit's Chief Commercial Officer at Luuk Strijers Luuk+S@deribit.com