acuiti management intelligence

Crypto Derivatives Management Insight Report

Q1 2023

Produced in collaboration with:

Cloudwall and DIGITAL ASSET RESEARCH

Table of Contents

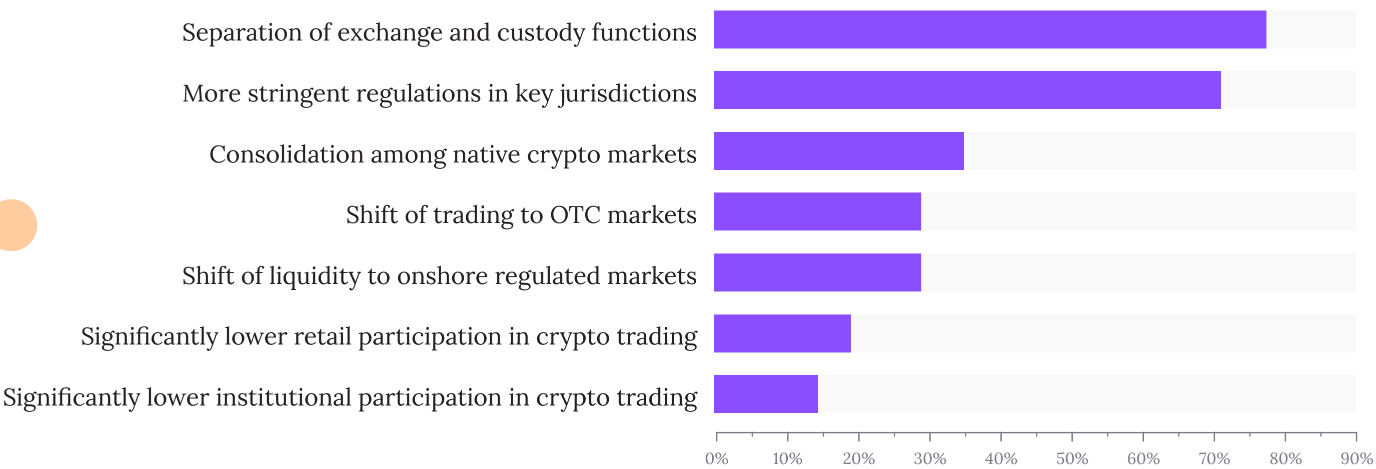
Life after FTX

The collapse of FTX in November 2022 sent shockwaves across the crypto market. While the reverberations are still being felt, the digital assets market has once again proved its resilience as it forges ahead learning the lessons of FTX and other notable disruptions during the year.

This quarter's Crypto Derivatives Expert Network Report, which is produced in collaboration with Digital Asset Research (DAR) and Cloudwall, takes a deep dive into how the collapse of FTX has changed the institutional crypto derivatives market.

The report is based on a survey of Acuiti's Crypto Derivatives Expert network, a group of over 70 senior executives from asset managers, hedge funds, sell-side firms, and proprietary trading groups active in trading crypto derivatives.

What do you think will be the long-term impact on markets structure of the collapse of FTX for institutional crypto derivatives trading?



The DAR View:
Increased industry oversight

DAR offers an unbiased, independent view of the digital asset market which is essential to manage risk and be prepared for current and upcoming regulatory frameworks. DAR offers risk management tools to evaluate assets, exchanges, and counterparties.

Members of the Expert Network expect the collapse of FTX to have a significant impact on market structure in the crypto-native derivatives market.

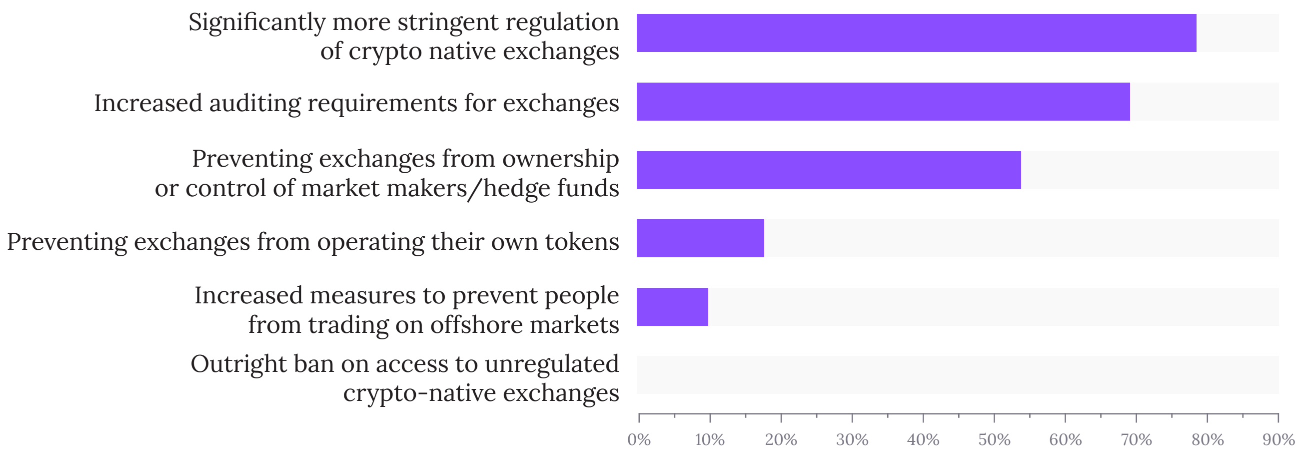
Over three-quarters of respondents thought that there would be a permanent separation of exchange and custody functions as investors look to reduce concentration risk. Almost as many respondents predicted a heightened regulatory response while around a third expected consolidation among crypto-native markets or a shift to OTC trading.

When it came to the most appropriate response to the FTX collapse, members of the Expert Network unsurprisingly called for greater auditing requirements for exchanges and more stringent regulation of crypto-native exchanges.

The latter presents a conundrum. Currently, most crypto-native derivatives exchanges operate in lower-touch regulatory jurisdictions. Many are currently looking to increase their regulatory credentials.

For example, Deribit is seeking regulatory approval in Dubai, where it plans to relocate its headquarters, marking the first step in its roadmap to greater regulatory oversight globally. Binance has now received a licence to operate in seven European jurisdictions.

What do you think the regulatory response to the FTX situation should be?



A similar catch-22 is true for auditing. Several of the major auditors have pulled away from working with crypto-native exchanges, presenting significant challenges for firms seeking audits from tier 1 and 2 auditors.

The result is that market participants have an increased role in auditing the exchanges on which they trade as they can't leave it to the top accounting firms or regulators. FTX brought to the fore the lack of transparency

The DAR View:
Concern over proof of reserves

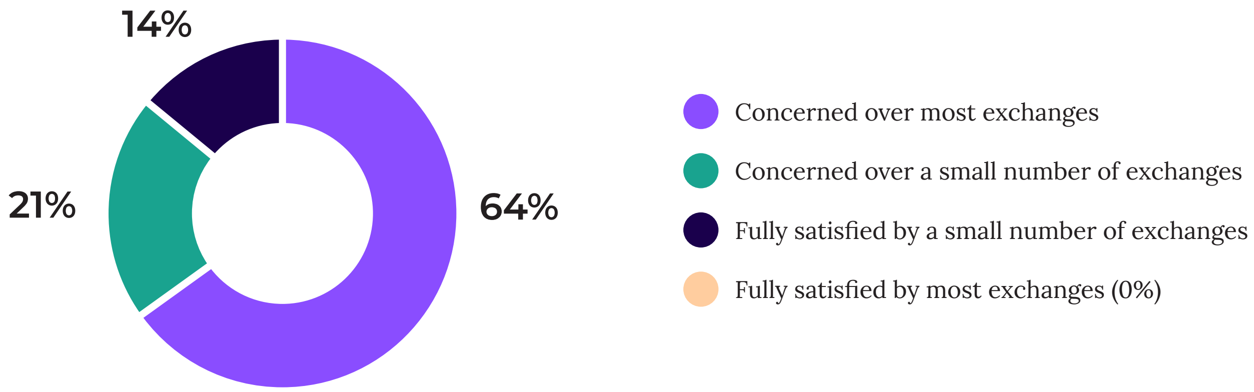
DAR Exchange Vetting reports provide a collation of information and proprietary analytics on the quality of a market including reserves, liabilities, and other key disclosures.

that the market has over operations of offshore entities.

In the wake of the collapse of FTX, exchanges rushed to publish proof of reserves to reassure nervous clients. These have been met with skepticism by members of the Acuiti Expert Network.

No respondents to the survey were satisfied by most exchanges' submissions and only 14% were fully satisfied by a small number of exchanges. Almost two thirds were concerned over most exchanges.

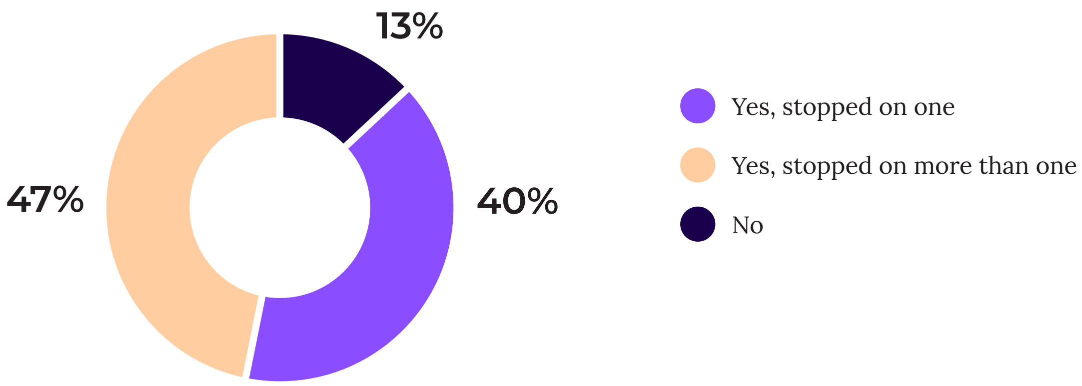
How satisfied overall are you with the proof of reserves from native crypto markets following the collapse of FTX?



Changing approach

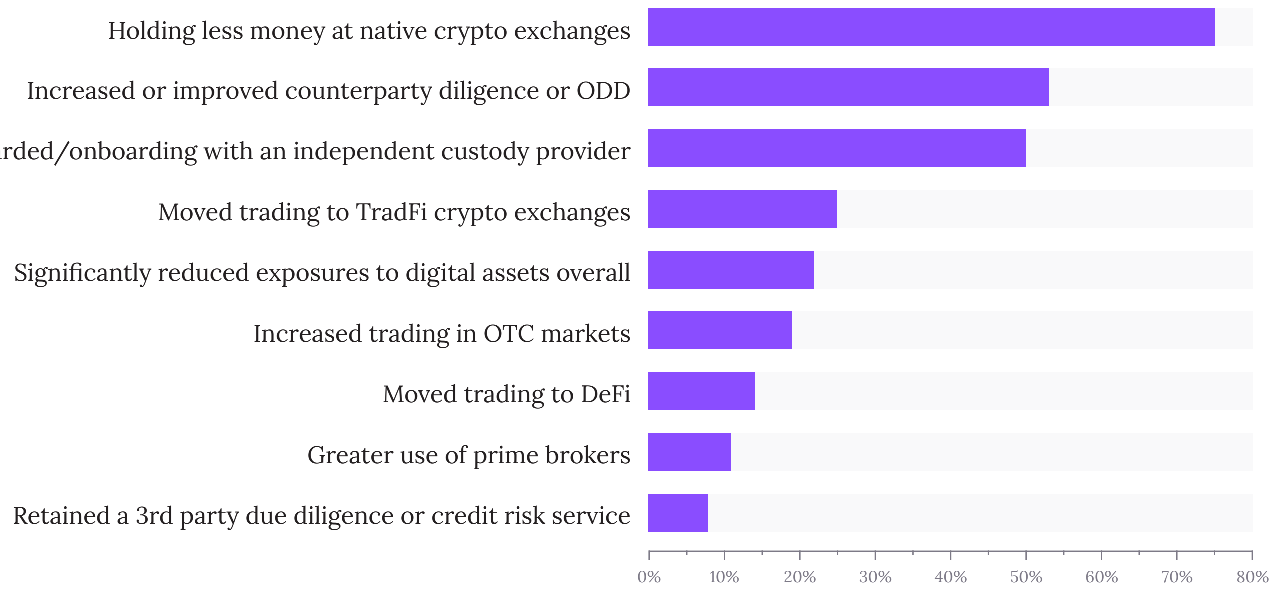
The collapse of FTX has inevitably changed how institutional firms approach the crypto derivatives market. Most notably, just under half of respondents have stopped trading on one or more exchanges (aside from FTX).

Have you stopped trading on one or more native crypto markets (apart from FTX) following the collapse of FTX?



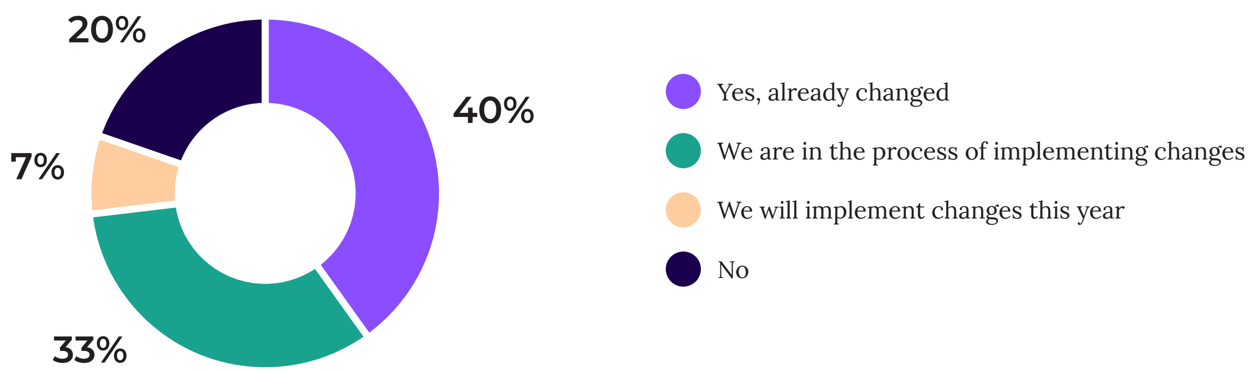
Firms have also made significant changes to how they engage with the market and monitor counterparty risk. Three quarters of firms are holding less money at crypto-native exchanges while half have onboarded an independent custody provider.

How have events of 2022 changed how your firms approaches crypto derivatives trading?



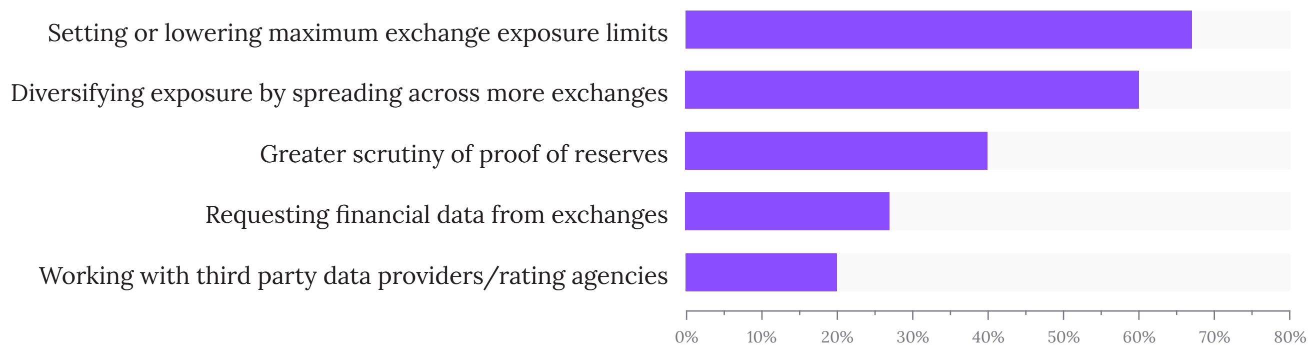
Members of the expert network have also changed how they monitor counterparty risk in crypto markets, with 80% of respondents implementing changes and almost half of those having already made changes.

Have you changed how you monitor counterparty risk in crypto markets as a result of the FTX collapse?



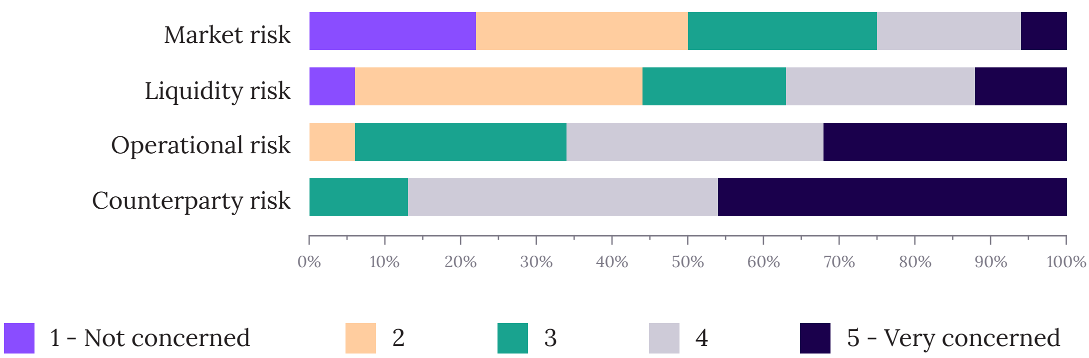
The most common changes made were setting or lowering maximum exchange exposure limits and diversifying exposures by spreading trading across more exchanges. This increases the cost and complexity of trading in crypto markets, requiring more capital to move between exchanges to trade and seize opportunities.

How have you changed/are you planning to change your approach?



Despite the changes to counterparty risk monitoring, it remains a key concern in the market. Almost half of the market was very concerned about counterparty risk compared with just 6% for market risk, 13% for liquidity risk and 31% for operational risk.

On a scale of 1 to 5 how concerned are you about the following risks in the market today?



The DAR View: Monitoring counterparty risk

DAR's Counterparty Diligence reports provide unbiased third party data and findings on a counterparty. The assessments help select counterparties that meet a firm's operational standards and assess the level of credit risk. The reports help identify and manage risks in any significant trading relationship.

Risk management takes centre stage

Investment in risk management from crypto derivatives trading firms is increasing in the wake of the collapse of FTX, with almost half of firms planning to invest in the area.

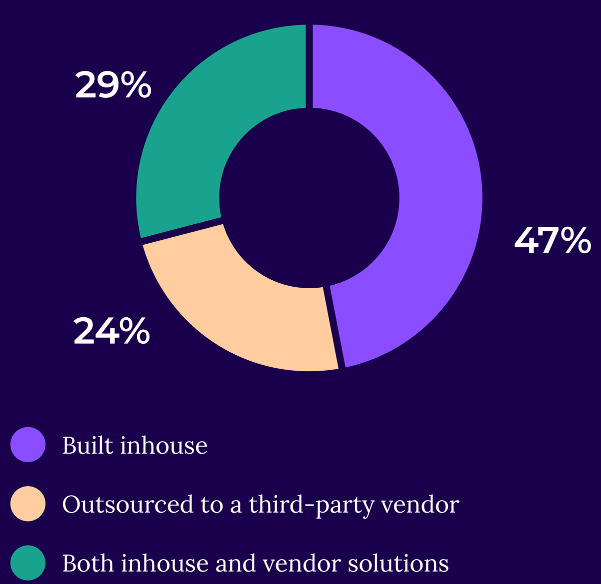
Currently just under half of respondents built their risk management software inhouse. Around a third have a mix of inhouse and vendor solutions and the remainder fully outsource.

Across all software, inhouse builds are more common than in traditional markets as firms developed their trading infrastructure while vendor solutions were less mature and many solutions are only now coming to market.

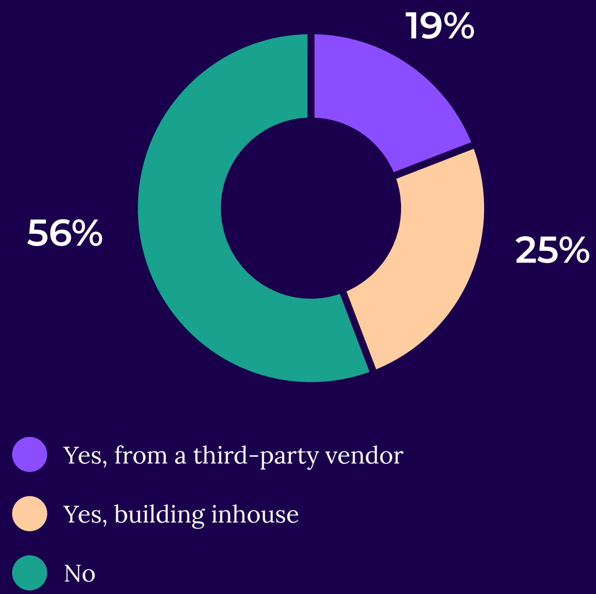
However, the survey found that firms with third-party software were less likely to be investing, which suggests that third-party solutions are now satisfying demand to a greater extent than inhouse builds. With that in mind, outsourcing is likely to increase in the coming years, as firms respond to the increased sophistication of third-party offerings.

Of the firms that were planning to invest, 58% were currently implementing that investment. The remainder were planning to invest in the next 12 months.

How do you currently source your risk management software?



Are you planning investment in risk management software?



The Cloudwall View: Market looks to third-party vendors

Serenity's PMS/RMS offers an easy-to-use, unified solution with data, risk models and risk tools to help active asset managers understand their market risks. Replacing Google Sheets and Excel-based summaries with a dedicated tool to assess and monitor risk lets asset managers focus on seeking alpha.

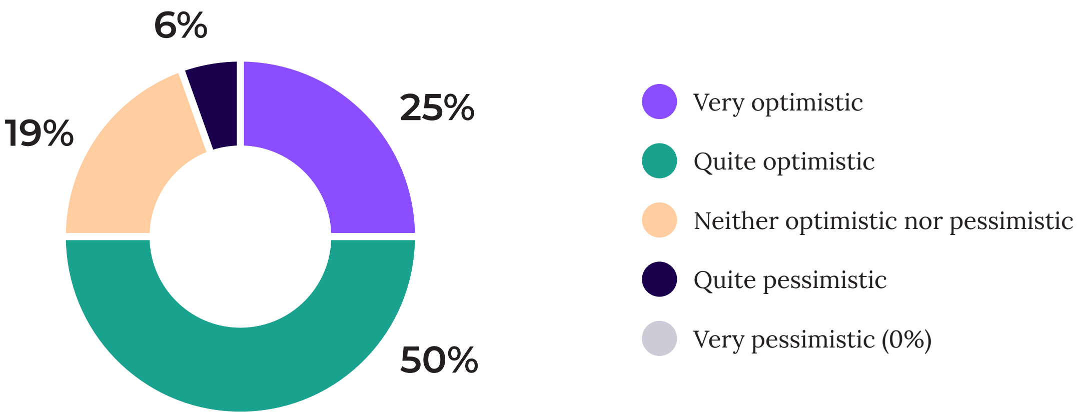
Moving beyond FTX

2022 was an immensely challenging year for crypto markets with significant falls in asset prices, the collapse of Terra/LUNA, the failure of several high-profile lenders and then the bankruptcy of FTX. However, the industry is weathering the storm, learning the lessons and rebuilding on stronger foundations.

The price of bitcoin is returning to its volatile past but remains relatively resilient and optimism is returning to the market. Overall, 75% of respondents to the survey said that they were either quite or very optimistic about the performance of their business over the next three months.

This points to better times ahead for crypto derivatives as the industry continues to innovate and develop new products. Several members of the Expert Network argued that FTX was a fraud and drew parallels with Bernie Madoff. While this is likely to be true (charges are still ongoing), the fact remains that the alleged misuse of customer funds would have been significantly less possible for an onshore regulated exchange.

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



Ultimately in the medium-term at least, market participants in the crypto derivatives market must assume far greater responsibility for oversight of their counterparties than they do in traditional, onshore regulated markets.

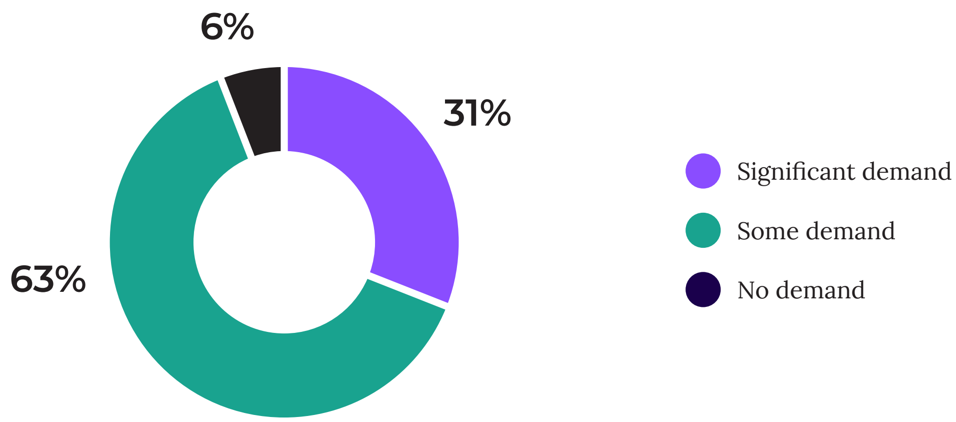
The industry was chastened in 2022 but looks set to come back stronger than before and investments made in improving risk management and counterparty risk management today will stand market participants in better stead to mitigate the challenges the industry will face as it further matures.

Demand for new products

While volatility in digital assets has been muted since the falls of 2022 relative to previous years, it remains a highly volatile asset class with strong intraday swings in prices. For institutional trading firms, this presents an opportunity.

But there is demand in the market for more products to capture those opportunities. 94% of the Expert Network thought that there was demand for a volatility index covering digital assets, with just under a third saying that there was significant demand.

Do you think that there is demand in the market for a volatility index covering digital assets?

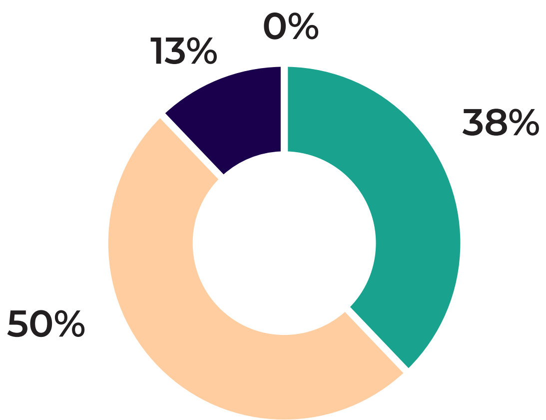


As this report was published, Deribit was set to launch futures on its DVOL index, which measures the implied volatility of Bitcoin. Members of the Expert Network, however, believe that a volatility index should have a wider scope than just BTC with 38% calling for BTC and ETH and 45% of respondents wanting it to cover most or all of the top 10 coins.

The Cloudwall View: New risk models for new products

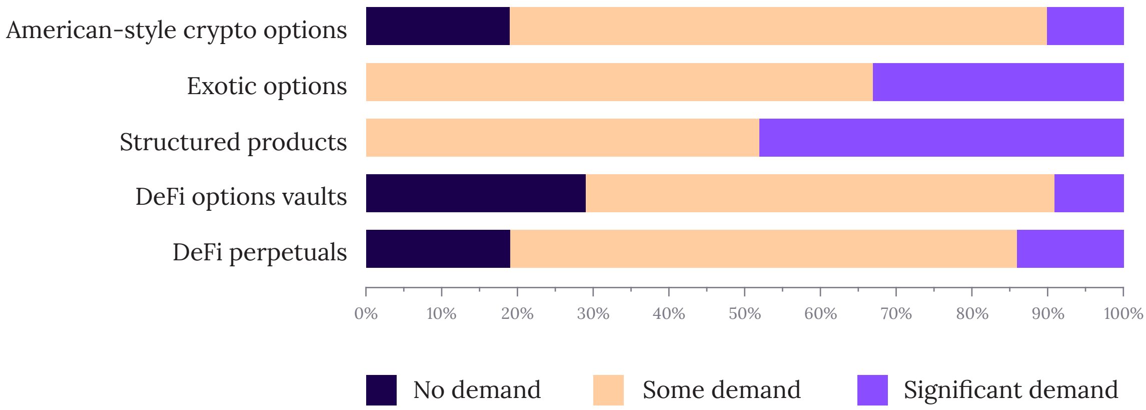
More sophisticated option products require institutional-grade risk engines to monitor complex risks. As the market evolves, Serenity's volatility model and option pricing engine will be upgraded to support American options and exotics.

Were a volatility index for digital assets to be launched, which coins should it cover?



Elsewhere, members of the Expert Network pointed to strong demand for more structured products, which reflects the increasing sophistication of trading strategies in the market.

Do you think that there is demand in the market for the the following products?



Respondents cited less demand for DeFi options vaults, American-style crypto options and DeFi perpetuals.

Q&A with Graham Rodford, CEO, Archax

Where are you with the build out of the exchange currently?

The Archax FCA-regulated custody service is live and we are actively marketing this and onboarding clients. Providing an institutional-grade, digital asset custodian, using an insolvency-remote structure where all client assets are held 1-for-1, is proving extremely interesting to people, particularly in a post-FTX crypto world

Our FCA-regulated exchange will be live later this month. We will have one market for regulated digital assets, like tokenised real-estate, equity, debt and funds, and an unregulated market for cryptocurrencies. Like our custody service, our crypto market looks like a traditional market, with all the controls and processes institutions need and expect, so providing trading in unregulated crypto assets for them in a familiar and acceptable way.

What role do you think regulated exchanges will play in the next phase of crypto trading?

With the turbulent times seen in crypto markets recently, it is only a matter of time before regulators around the world tighten their grip on the space and regulate cryptocurrency instruments themselves or activities involving them, or both. I think the crypto community generally welcomes this– and it is essential for mainstream institutions to get involved anyway.

We've always believed that this day would come – maybe a little sooner than originally expected! And we've built Archax to provide regulated exchange, broker and custodian solutions, for all types of digital assets, accordingly. So, with this change coming, regulated markets as well as other services are going to be key for the growth of the crypto space with this new focus from regulators.

Where are you seeing interest from in onboarding to trade crypto?

Right now, we are seeing a lot of interest in our digital asset custody service as people recognise what went wrong at FTX and others, and are now looking for safe, credible alternatives that provide the right level of service in the right way. On the crypto trading side, volumes are clearly down. What we see is that those institutions that were already involved in crypto, are believers and still there – albeit in a rather more conservative and measured way. For those institutions that haven't got involved yet, they seem to be happy to remain on the side-lines right now until some stability returns, and the path forward for the space becomes clearer, particularly from a regulatory standpoint.

You are pioneering the trading of digital securities, what potential do you see here and how will the market develop?

Cryptocurrencies are really just the first use-case for the underlying blockchain/DLT technology and concepts like tokenisation. They have pioneered what can be done and proved the potential way forward for other use cases. Digital Securities is one such use case – leveraging these same concepts to create a new way of recording ownership of an asset and provide investment opportunities in it in a much more democratic and efficient way.

The key difference is digital securities are regulated instruments and trade on regulated markets, so are much more familiar and palatable to financial markets institutions. Examples we see are: people tokenising equity or debt to raise money from new digitally-connected communities; assets like real-estate being opened up to allow direct access for new investors; and tokenised funds, where secondary markets can be created to allow people to trade in tokens outside of normal redemption cycles and create a permanent source of capital for fund managers.

Archax is built on a blockchain platform, what benefits does that bring to market participants and what are the current limitations of the technology?

Archax is actually blockchain agnostic and supports a wide range of leading DLT solutions. Some of the key benefits that the technology brings, include: opening up access to previously hard to trade assets; bringing liquidity to currently illiquid assets; opening up investment opportunities in assets to new investors; creating new innovative digital instruments and structured products; and improving the efficiency of maintaining ownership records of assets and then trading them – particularly in the post-trade space.

One of the key limiting factors for digital securities and the use of blockchain technology to realise its full potential, is regulation – which is currently designed for the legacy solutions that are in place, and so can limit the benefits that could be gained. An example of this is the mandated use of Central Securities Depositaries (such as Clearstream or Euroclear CREST) in the UK/EU to record ownership of any asset that is admitted for trading on a regulated secondary market. As such, for digital securities you end up with two records of ownership – one on-chain and the other in the CSD. This is inefficient and limits many of the other potential benefits of having digital tokens involved. A solution for this is to have a digitally-native, blockchain-based CSD, so that both records of ownership are one and the same. At Archax we have set up a subsidiary – Montis – which is developing just that.

What do you see as the future market structure in a DLT-enabled world?

We believe that all traditional financial markets will move across to leverage blockchain/DLT technology and tokenisation – as it is simply a much better and more efficient way to run markets. One only has to look at what has happened in other industry segments – such as the music industry, for example. We all used to buy vinyl, then cassette tapes, then CDs, then we downloaded music to devices, and now we stream it live without even thinking about it. Music hasn't really changed – apart from genres coming or going in terms of popularity – but the way we consume it and the commercial model involved is completely different. The DLT-enabled financial markets world has the potential to do the same for capital markets.

What is next for Archax?

We are now working closely with a number of leading financial institutions looking at leveraging tokenisation to create innovative financial products – such as with abrdn who invested in our Series A raise last year. As well as providing a market for others to list digital asset products, we are also keen to leverage the technology to create interesting, regulated, institutional-grade products of our own. We are also currently working on a range of regulated crypto ETPS (exchange traded products), as well as looking at other regulated security instruments that can give access to ETH staking exposure and Bitcoin mining hashrates. What is happening currently in the DeFi space is really interesting too, and we are looking at ways to leverage the technology and concepts being pioneered there, but in an institutional, regulated way.

About Digital Asset Research:

Digital Asset Research (DAR) is a specialized provider of highest quality 'clean' digital asset data and insights for institutional clients. Since 2017, DAR leads by rigorously vetting exchanges, counterparties, and assets to eliminate the noise for flagship clients such as Bloomberg, Chainlink, FTSE Russell, and Wilshire. Using crypto and traditional finance expertise, DAR combines consolidated market data feeds and risk measurement tools, including counterparty diligence, for clients seeking to identify the best crypto spot and derivatives markets and avoid the next FTX. DAR's success is driven by its independence and a commitment to deliver 'clean' data emphasizing accuracy, quality, and transparency.

FOLLOW DAR:

Twitter: @DAR_crypto

LinkedIn: https://www.linkedin.com/company/digital-asset-research/

Medium: https://medium.com/digitalassetresearch

About Cloudwall:

Cloudwall is a software provider offering a range of digital asset risk models and tools for crypto spot and crypto derivatives as part of its cloud-based Serenity risk management platform for institutions. Models include factor risk; PCA; an SVI-based volatility model; and historical VaR. Tools include portfolio risk attribution; portfolio stress testing; OTC & listed option pricing; visualization of BTC/ETH yield curves and volatility surfaces; portfolio VaR calculation; and portfolio VaR backtesting. Cloudwall is committed to offering a full suite of real-time portfolio risk tools for the full spectrum of risks faced by active asset managers trading in digital assets today, across the full range of instruments, including spot; listed derivatives; OTC derivatives; and DeFi. Visit https://cloudwall.tech for more information or request a demo.

acuiti management intelligence

0203 998 9190

acuiti.io

info@acuiti.io