2021 Roadmap to Institutional Adoption

LIQUIDITY SECURE CUSTODY CLEARING & SETTLEMENT

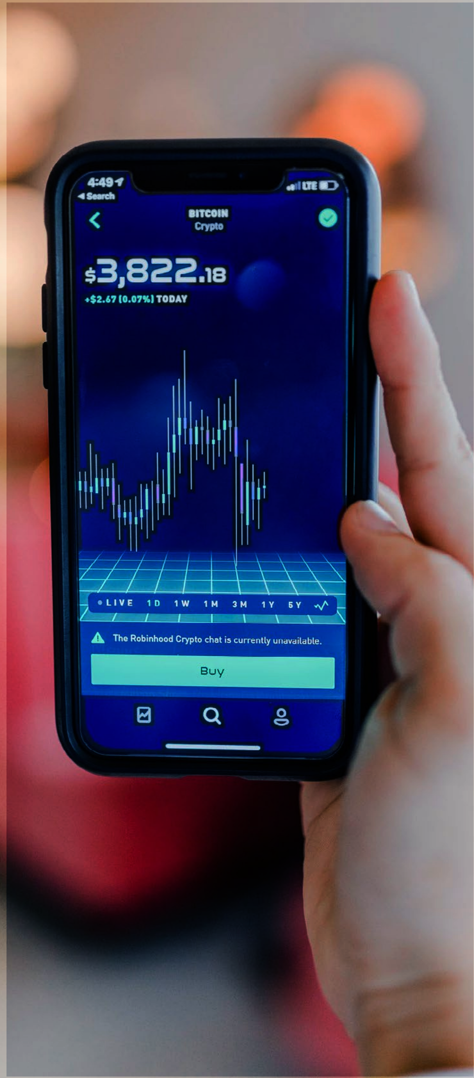
GCEX Trustology BOSONIC

Series Introduction

The cryptoasset market continues to evolve and grow at lightning speed. The emergence from the crypto winter ushered in more mature legal and regulatory frameworks thanks to AMLD5, and now stands at an all-time high.
A week into the new year, 2021, and the market value of all the world's cryptocurrencies surpassed $1 trillion with crypto itself recognised as the fifth-most circulated currency by value.

This in conjunction with quantitative easing putting pressure on investors to diversify from fiat is making it an attractive sell and examples of mainstream institutional adoption abound. From global banks such as Fidelity and Bank of New York Mellon now bucking the trend, to dozens of corporations now holding cryptoassets on their treasury balance sheets as a reserve. In fact, you can't turn on the TV or open the FT or WSJ without the latest on some institution adopting digital assets. However, whilst crypto is rife with opportunity, it is still an immature market full of complexity and risk. It is easy to lose your assets or fall foul of regulation if you don't know what you are doing. In this four-part blog series, we aim to offer a simple step-by-step guide as to how traditional brokers and startup cryptocurrency brokers can balance opportunity versus risks in cryptocurrency trading.

Traditional funds or crypto funds seeking to generate returns or yield may also find some benefit to reading our series, but we'll be coming out with a more tailored series for funds next. Written by veterans from capital markets, banking, blockchain and fintech who are crypto converts themselves, learn how to bridge the best of two worlds of finance and avoid potential pitfalls and difficulties when contemplating exploring this new asset class.



Making the business case for crypto trading

First and foremost, with all the excitement being generated in this market, one must first make the business case for crypto. Are you an FX broker looking to expand a product offering? Or are you contemplating starting a crypto brokerage? Better still are you a newly formed brokerage trying to navigate the waters? How many of you are already trading crypto? What are your liquidity sources? How do you handle crypto custody? How do you face your counterparties and settle trades without risk? Whatever the case may be this series is intended for you.

Once the initial business case is made, where and how to buy cryptoassets is the first stumbling block. As regulated entities, brokerages need to be able to deliver their crypto offering 24/7 to both retail and institutional clients in a proven and compliant manner, without the huge upfront investment in legal, regulatory or technology.

For all parties, liquidity is critical, and then to manage the delivery if required. Institutional liquidity requires committed market makers and stable infrastructures to ensure best and transparent execution. When volatility increases, slippage can become a real problem, and for larger volumes even more so as market makers withdraw. Current crypto exchange infrastructures seem to also to have problems during high demand.

Execution against a regulated liquidity provider as a riskless principal does not allow for certain conflicts of interest, such as front running, aggressive margining on perpetuals (CFDs) or leverage and internalising trades that could occur with an exchange. Popular venues also trade with a perpetual swap, in which the intraday margin is mostly tailored to the books of the exchanges.

> *Large numbers of clients wish to engage counterparties that have a lot of similarity to traditional financial institutions. Being insured or regulated and having a previous track record, are a must for those from the "old" world to start engaging in Crypto and Digital Assets. There is a lot to explain, and it starts easiest with familiarity.* **Lars Holst** | Founder and CEO, GCEX

The current liquidity and infrastructure for crypto are highly fragmented compared to FX, some in the space are charging 1-3% to transact in this market, much similar to FX in the 1980s- 2000s, as it grew up, fees and commissions decreased to a few basis points. There is a perceived opportunity from FX buccaneers and innovators to bring this asset class to port with them and seems to be the type of broker most likely to offer this as an add-on in the traditional space, first via CFD in 2017 onwards.

Crypto exchanges have suffered from growing outside traditional finance, and although this has produced innovation, it has left traditional counterparties to either build bespoke solutions or hire additional compliance and consultants to get it right. If integration is perceived too cumbersome, branching out to this new asset class seems impossible, especially in a large institution where there are many stakeholders to convince. A set-up that is "out-of-the-box" via traditional connectivity or a plug-and-play solution allows the business case to be made, both for cost-effectiveness and risk management.

Venues that are tailored to institutional flow from traditional markets provide a conduit to “old world” players to access liquidity via standard trading protocols such as FIX or are already compliant in a number of areas and are insured, which provides some protection against regulatory changes in the future.

Trading Bitcoin or Ethereum and a number of other top tokens need not be cumbersome and simple solutions inline with industry standards in traditional financial markets are emerging. A solution initially may involve a brokerage also supplying custody, but to avoid counterparty risk, it is worth considering exchange custody and client-side custody, moving the asset to and from the trading party as part of a standard EoD process.

> *Excellence in overcoming inherent risks and complexities of cryptoasset safeguarding and administration, is becoming a key selection criteria for clients choosing institutional investors and service providers.*
>
> **Alex Batlin** | FA Founder and CEO, Trustology

Counterparty credit and settlement risk, one of the biggest impediments for institutions entering the crypto market at scale, is rooted in the lack of credit intermediation services guaranteed by big bank balance sheets - the core function of traditional Prime Brokerage. This is being overcome with the emergence of technology that delivers real-time atomic exchange of assets, trade and payments netting and clearing and settlement automation. With atomic exchange the trade is also the settlement and ownership changes in real-time on custodial blockchain ledgers eliminating trading counterparty credit and settlement risk.

The same technology can support a lending marketplace that facilitates frictionless crowdsourcing of virtually unlimited balance sheet for intra-day financing of trades. By employing collateral resting in custodial accounts without having to move it and implementing borrows as real-time repo transactions on custodial blockchain ledgers, the entire spectrum of trading from fully funded, to margin to fully on credit can be supported with no trading counterparty credit or settlement risk by shifting risks to a diverse range of lenders.

> *Pure technology can provide an alternative to credit intermediation without having custody or control over client assets, without becoming a counterparty to the transactions and without using or being limited by balance sheet. Through the digitization of assets held in a member's own custodial account, real-time atomic exchange of assets, trade and payments netting, clearing and settlement automation, the right technology infrastructure can eliminate counterparty credit and settlement risk.*
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> **Rosario Ingargiola** | Founder and CEO, Bosonic

The idea of the "new normal", under the pandemic, has propelled digital transformation to the front of all CEOs minds. If disruptive and innovative technology has taught us anything, it's to always 'think ahead' as the future is unpredictable but full of promise if you know where to look. In crypto markets, decentralised finance or DeFi and its applications look to be defining the future of finance. It is an ecosystem built around democratising finance and reducing the dependence on middlemen and third parties that plagues current centralised infrastructures causing unnecessary and non-transparent market friction.

For brokerages and funds, it represents an opportunity to tap innovation for yield opportunities and decrease settlement costs. For the more adventurous searching for “Alpha”, DeFi could add revenue from flash loans, flash swaps, automated market making, decentralised exchanges, decentralised governance, and initial DeFi offerings. In the final part of this, we explore the emerging initiatives in this space and how best to navigate this burgeoning ecosystem. **Remaining compliant and secure in a new frontier of technology and opportunity.**

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First up in our series:

How do I connect to liquidity: “The Crypto Gateway”

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