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VOLUME 3

CoinShares Perspectives

TOPICS

EU REGULATION
US ELECTION
VOLATILITY
OPTIONS MARKETS

From the Chairman's Desk

As Chairman of CoinShares, Danny Masters draws upon his decades of experience in commodities and finance. Danny launched GABI, the world's first regulated Bitcoin fund in 2014, through Global Advisors, a commodities focused investment firm which he co-founded in 1999. Danny was Global Head of Energy and Trading at JP Morgan and has traded "more oil contracts than any single person."

ITS POLITICS ALL THE WAY DOWN

It's been a busy month on the policy front, with the US election looming and the European Commission (EC) getting more organized and coordinated around its approach to crypto. Let's start with the recently published EC proposals. For several years, as highlighted by last year's much contested Financial Conduct Authority Paper CP19/22, there has been, in the UK at least, a very strong lobby against crypto as an industry and as an asset class. Much of this negativity has emanated from the UK, and it has largely been focused on the suitability of bitcoin and other types of digital assets as an *asset class*. This mantra was being evangelized by the FCA who made clear the desire to see crippling rules and bans put on crypto assets.

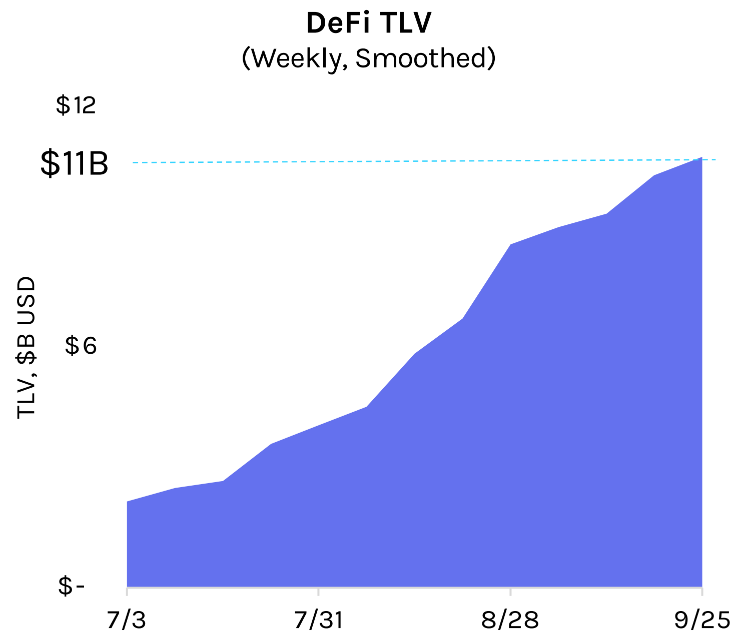
The proposals from the EC debunks all of this and shows a sensible attitude toward taking digital assets into the mainstream. While final adjudication from the FCA is not currently forthcoming, the implications for the United Kingdom, particularly post Brexit on December 31st, of taking a recalcitrant position will be laid bare by the positivity in Europe and could very well put the UK at a major disadvantage. As a firm with a large presence in the UK, we are eager to see more sensible and practicable policies emerging.

For our colleagues in New York, and for capital markets more broadly, the US Election will be conducted in an atmosphere of heightened partisanship, tension, and division. The untimely passing of Ruth Bader Ginsburg has further exacerbated these divisions, along with the US Postal Service scandal, Trump Tax returns, John Bolton book – the list goes on and on. The impact of the election will not just revolve around the Presidency but will be impacted by the winning party in the House and Senate also. The matrix of outcomes all lead to a weaker US Dollar - with the exception of a Republican sweep - which seems unlikely. As expected, a weaker US Dollar is a bitcoin positive, but probably not a strong one. Should power swing to the Democrats, the resulting pressure on equities may be a strong negative also. All in all a mixed bag, we'll be watching closely to see how it unfolds.

DECENTRALIZED FINANCE IS EATING THE WORLD

As our team at CoinShares has articulated in the past, the vision for financial system re-engineering revolves around a three layer structure of 1) Central Bank Digital Currencies (and other legitimately issued digital assets) 2) Products and services, formerly offered by commercial banks, such as hypothecation, borrowing, lending, trading, credit rating, etc and 3) end point architecture.

DeFi is the second layer while many projects are no more than proof of concept and understanding the limitations of the Ethereum Virtual Machine, it is impressive to see working solutions in this second layer. I expect much more development in this area, however the largest sticking point is that, currently at least, the challenges of KYC are not being met to a degree that would support commercial scaling.



Source: DeFiPulse.com, data pulled weekly

From the Trading Desk

CRYPTO MARKETS BACK TO BORING, FOR NOW

Bitcoin has been trading between $10k and $12k since the beginning of August, and Bitcoin volatility remains very close to its lowest level. A lackluster end of month with bitcoin options expiry, low volatility, and a range-bound trading environment all leading to one conclusion - investors aren't rushing in to increase their exposure. We expect to stay in this configuration and that signs of a change will first be reflected in the options market.

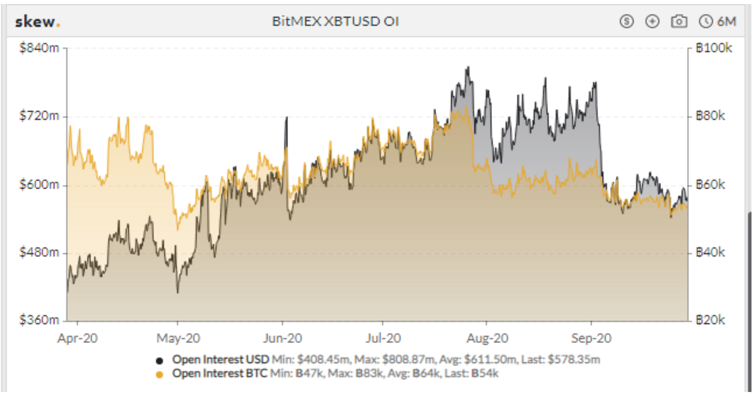
Future basis levels are also in a very shy contango and have even been from time to time in backwardation for the 3 consecutive weeks on Ethereum showing limited bullish perspectives. Finally, the volatility curve flattened reinforcing the market sentiment that this tunnel won't be breached in the short term.

Open interest for the Bitmex Perpetual Swap (arguably the most liquid contract out there) has cratered since the beginning of the month which is indicative of trader's anticipation of there being little action for the month of September and the near future - why pay a funding rate to be long and leveraged if no action is anticipated? Similarly, the funding rate has been very indecisive even flipping to pay the long in an attempt to gather some interest (another if needed suggestion that there is little appetite for near term leverage)

We are actively trading the options market, which continues to grow, with nearly 90,000 contracts in September expiry. The options market has exactly the same information as the spot market, so the size of the expiry theoretically shouldn't influence the spot price of bitcoin. The traditional CME options market has now traded BTC options for quite some time and is growing, this coupled with the non-regulated options markets nearly matched the trading volumes seen in the spot market.

By our estimates, the spot markets trade at around $6-8 B per day and the options market is rapidly approaching these levels. At the very least, the growing options market is indicative of the increasing confidence of investors and the broader legitimization of BTC, this in itself should help support prices.

Open Interest of the BitMex Perp Swap



Source: skew.com

The correlation between Bitcoin and the stock market is very high compared to historical levels, and Bitcoin seems to be stuck in the same pattern as US equities. Per Danny's comments, more clarity on the election cycle and additional stimulus should help get things moving.

On the ETH side, the DeFi craze brought a hoard of newcomers in September. The impact of this influx seems to be limited to ETH and the related DeFi tokens. However, ETH has struggled to follow the pace of BTC and has suffered from a lack of performance since August. There was a big ETH expiry on Sept. 25th, another non event despite ETH volatility outpacing BTC one. This is most likely due to the unwinding of the DeFi trade. ETH generally has a high beta to Bitcoin, and when BTC moves ETH often moves to a greater degree.

This seems to benefit alternatives blockchains like Tron or NEO. Derivatives volumes is weak and in turn reflects the ranging sentiment but the option open interest continues to increase steadily.

Regulatory Affairs

Nick du Cros, UK Compliance & Regulatory Affairs

FINALLY, LEGITIMACY FOR CRYPTO ASSETS?

It is hard not to overstate how important the release of the European Commission's proposals on crypto assets will likely be on the timeline of legitimisation. After all, it was only in January 2019 when the European Securities and Markets Association recommended against a bespoke regime for cryptoassets arguing "Wider regulation of crypto-assets and related activities may have trade-offs, such as risking legitimising crypto-assets and encouraging wider adoption. It will also require further supervisory resources."

Now, with the recognition that cryptoassets have a role in helping Europe's post-pandemic recovery process, "Embracing digital finance will contribute to the overall digital transformation of our economy and society. This would bring significant benefits to both consumers and businesses."

Last week the European Commission formally published a holistic set of digital finance initiatives including a:

- Digital finance strategy;
- Regulation for a markets in cryptoassets (MiCA);
- Pilot market infrastructure based on distributed ledger technology;
- Digital operational resilience in financial services; and
- Retail payments strategy.

Broadly, MiCA proposes the implementation of a harmonised framework across the European Union for issuers of cryptoassets, issuers of stablecoins (to be known as asset referenced tokens) and cryptoasset service providers.

In our view the approach of the European Commission demonstrates a sensible starting approach towards taking digital assets into the mainstream. However, there are still areas which could be improved, and hopefully there is sufficient time to lobby for sensible amendments before the European Parliament officially adopts.

"A crypto asset itself doesn't require a 10 year fixed term lease for office space in an EU member state to be available to EU consumers."

By way of example, the proposed requirement for issuers of asset-referenced tokens to have a six monthly independent audit of the reserve assets (i.e. the underlying assets backing the asset-referenced token). This seems to be an effort to retro-fit the traditional auditor-investment manager relationship onto crypto. So before hard coding this as the only permissible method we should consider the potential of the blockchain and blockchain technology to provide the verification of cryptoassets held. CoinShares recently partnered with Armanino to produce a real time attestation of the underlying assets held against the liabilities of its ETNs. Investors can go to a public website and view an attestation report which is updated every 30 minutes.

We also think that more work needs to be done to make the proposed regime more available to service providers who are not based in the EU. The very nature of the 21st century digital company is that it can be based anywhere in the world. So the proposed requirement that services should only be provided by a legal entity that has a registered office in an EU Member State will increase costs, which will ultimately be passed through to consumers. The crypto asset itself doesn't require a 10 year fixed term lease for office space as part of its programming to be available to EU consumers! Perhaps acknowledging this, tucked towards the back of MiCA, is the requirement to prepare a report on the functioning of MiCA and a compilation of certain metrics. One of the items to be specifically considered is "whether an equivalence regime should be established for third-country crypto asset service providers". Sadly, this report is scheduled for delivery 3 years after MiCA has commenced, which is a lifetime in crypto.

AND WHAT OF THE UK?

For several years now there has been a strong lobby against crypto in the UK. Whether it was the recent HM Treasury Crypto Consultation (July 2020) to introduce more crippling rules on the sector, or the FCA CP19/22 (July 2019) proposal to ban cryptoderivatives (including ETNs), the focus of UK regulators appears to be solely on investor protection, without due consideration for future innovation and competitiveness. As Danny alluded to, the implications for the United Kingdom, particularly post Brexit on December 31st, of taking such a recalcitrant position will be laid bare by the positivity in Europe and put the UK at a major disadvantage.

ABOUT COINSHARES

At CoinShares, our mission is to expand access to the digital asset ecosystem while serving as trusted partners for our clients. CoinShares is a pioneer in digital asset investing and manages hundreds of millions in assets on behalf of a global investor base, with offices in Jersey, Stockholm, London, and New York.

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