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Contemporary Challenges of OTC Trading in Digital Assets

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***Abstract*—As the world population at large begins to comprehend the depth and prospective impact of blockchain technology, the demand for purchasing cryptocurrency has been steadily increasing. OTC trading, also known as over-the-counter trading or off-exchange trading, is a digital asset trading service that is traded through a private, peer-to-peer, dealer network as opposed to a centralized, formal exchange such as the New York Stock Exchange (NYSE). Currently, the value of institutional daily cryptocurrency traders, which frequently make large-block transactions on a bi-lateral basis, is about two-to-three times the value of exchanges. As more institutional investors, large firms, and other major players enter the cryptocurrency market, the volume of large quantity cryptocurrency trades has been steadily increasing. According to a report by Reuters, OTC cryptocurrency desks frequently facilitate over $100 million USD in transactions daily.**

Keywords—new realities; over-the-counter trading; OTC trading; blockchain technologies; digital currency; virtual currency; tokens; institutional and private investors; hedge funds; family offices; exchanges

I. INTRODUCTION

The innovation of blockchain technology and its implications for utilization among a wide variety of industries continues to fuel activity within the cryptocurrency market. Its obvious benefits in terms of speed, security, and cost due to blockchain's decentralized nature have the potential to alter not just the currency we use, but our purchasing methodologies, and conceivably also the way we travel, shop, crowdfund, and more.

As the world population at large begins to comprehend the depth and prospective impact of blockchain technology, the demand for purchasing cryptocurrency has been steadily increasing. At the time of writing, over 2,100 cryptocurrencies are available, according to investing.com's list. As of October 2018, more than 300 crypto-focused hedge funds have been created [1], and traditional trading companies continue to show increasing interest in their exposure to blockchain assets [2].

According to a survey by Thomson Reuters, one in five financial companies plan to integrate blockchain-based cryptocurrency trading into their scope of services. Of the 400 firms the data and news agency queried, which included bank trading desks, hedge funds, and large asset managers, 20 percent are considering trading in cryptocurrency within the next 12 months; the majority planned to do so within three to six months [3].

Major players such as NASDAQ are considering launching a cryptocurrency exchange, according to CEO Adena Friedman, and it recently announced that its SMARTS Market Surveillance technology will be used to monitor trades and detect fraud at Gemini, a cryptocurrency exchange created by the Winkelvoss twins. Other foremost financial entities are entering the digital asset space too: Goldman Sachs and one of the world's largest banks, Mitsubishi UFJ Financial Group, both plan to launch a cryptocurrency exchange [3]. And in September 2018, Citigroup Inc. announced plans that it is developing Digital Asset Receipt (DAR), a product that will allow trading in cryptocurrencies without requiring ownership of them.

However, it's not just traditional exchanges and banks that are warming to participating in the arena of digital assets. In the spring of 2018, billionaire investor George Soros's family office gained approval to trade in cryptocurrency [4]. In January 2018, owner of the New York Stock Exchange, the Intercontinental Exchange (ICE), launched its Cryptocurrency Data Feed (CDF), which aggregates the data of 15 cryptocurrency exchanges, providing key information to hedge funds and banks, and in August 2018, it announced the formation of Bakkt, a global ecosystem for digital assets [5]. Beginning December 12, 2018, Bakkt will launch its futures contract, which will be physically settled [6].

II. OTC TRADING IN DIGITAL ASSETS

As large financial institutions start entering the cryptocurrency market, the digital asset space is given more legitimacy in the broader financial markets, thereby increasing trading volumes and lifting prices. The impact of their involvement also means that the appeal of over-the-counter (OTC) trading has been increasingly on the rise.

In fact, institutional trading accounts for a substantial percentage of the cryptocurrency market share. However, the majority of institutional money has not been invested yet, largely because regulatory clarity, institutional-grade data, and enterprise-ready market infrastructure are not yet extant.

Moreover, the potential growth of institutional investment is formidable [7].

The opportunity that is looming is also emphasized in the data below, which shows how small the crypto market is in comparison to traditional gold shares, suggesting the likelihood of further improvement in the crypto market. Given cryptocurrency accounts for $205.8 billion USD of $83.6 trillion USD of the world's economy, the growth potential of digital assets is clear.

Currently, the value of institutional daily cryptocurrency traders, which frequently make large-block transactions on a bi-lateral basis, is about two-to-three times the value of exchanges.[10] As more institutional investors, large companies, and other major players enter the cryptocurrency market, the volume of large quantity cryptocurrency trades has been steadily increasing:

According to a report by Reuters, OTC cryptocurrency desks frequently facilitate over $100 million USD in transactions daily [8].

Genesis Global Trading trades $75 million USD to $80 million USD daily, and in December 2017, it achieved a monthly record of facilitating between $1.5 billion USD and $2 billion USD in trades [8].

In 2017, fintech startup Circle facilitated almost $4 billion USD OTC trades a month and doubled its minimum order size to $500,000 USD, with an average ticket size of $1 million USD [8].

Complications of selling Altcoins for Fiat OTC: Despite the exponential growth in OTC cryptocurrency trading, many OTC desks have been incapable of securely and efficiently exchanging a high volume of altcoins into at. Following are the complications they typically encounter:

- Banks do not typically provide or support the service because they are not equipped to deal with an array of cryptocurrency.
- There is a risk of not receiving the expected amount of fiat for the deal.
- The cryptocurrency buyer does not have sufficient liquidity in at.
- The time frame to credit the funds to the seller’s account is not fixed.
- There is a lack of variety of altcoins available for the deal.
- There is no legislation concerning trading digital currency in the country in which a cryptocurrency deal is made.
- There is a lack of legal transparency of the deal.
- The buyer of altcoins resides in a jurisdiction that deems these digital assets as unregistered securities.
- It is difficult to properly vet counterparties to ensure there is no illegal laundering of funds [9].

III. The Advantages of OTC Cryptocurrency Trading

OTC cryptocurrency trading also caters specifically to each particular client, providing a high- level of personalized services. For institutional investors and other high-volume market players, this aspect of OTC cryptocurrency trading can be extremely desirable.

Despite the existence of a wide variety of cryptocurrency exchanges providing simple cryptocurrency- to-cryptocurrency transactions, traders who want to exchange cryptocurrency-to- at, especially in large volumes, typically decide to use OTC cryptocurrency trading for the following reasons:

- OTC trading offers altcoin-to- at trades and at-to-altcoin exchanges.
- OTC trading provides better prices.
- OTC trading has much higher trading limits.
- OTC trading offers faster trading times.
- OTC trading offers more security.
- OTC trading offers personalized attention.

IV. The Potential of OTC Cryptocurrency Trading

In April 2018, international research company TABB Group released a report that examines the increasing role that institutional investors and high-net-worth individuals play in the cryptocurrency trading markets. The report, titled “Crypto Trading: Platforms Target Institutional Market”, concludes that institutional trading accounts for a significant percentage of the cryptocurrency market share. But the report also notes that the majority of institutional money has not been invested, because these institutions are waiting for regulatory clarity, institutional-grade data, and enterprise-ready market infrastructure. In other words, the growth potential for institutional investment remains extremely high, and in fact one market participant remarked that there is a "well of institutional money just waiting for the right conditions to enter the market".

By polling institutional investors at a recent Context Summits conference, TABB Group ascertained that 11 percent of the 400 market participants surveyed foresee allocating to crypto funds within the year, representing a combined total of $5 trillion [10].

About 25 percent of these market participants were from family offices, while the remaining 75 percent were hedge funds, consulting firms, endowments, foundations, sovereign wealth funds, and pensions.

Worldwide, crypto institutional investors comprise:

- INDEPENDENT LPs & MARKET MAKERS
- INSTITUTIONAL LPs & MARKET MAKERS
- CRYPTO-FOCUSED FUNDS

- MINERS
- VENTURE CAPITAL & PRIVATE EQUITY COMPANIES

By conducting interviews with OTC market participants, coupled with market evaluation, the data collected by TABB Group establishes that two to three times more cryptocurrency volume is being transacted OTC than on the global bitcoin exchange market, with daily OTC values amounting to $30 to $150 billion USD. Approximately 80 percent of institutional crypto fund activity is long only, signifying the nascent state of this market [10].

TABB Group's "Equities Liquidity Matrix Report" shows that OTC markets had almost 40 percent of the market share of overall cryptocurrency trading volume as of January 2018 [10]:

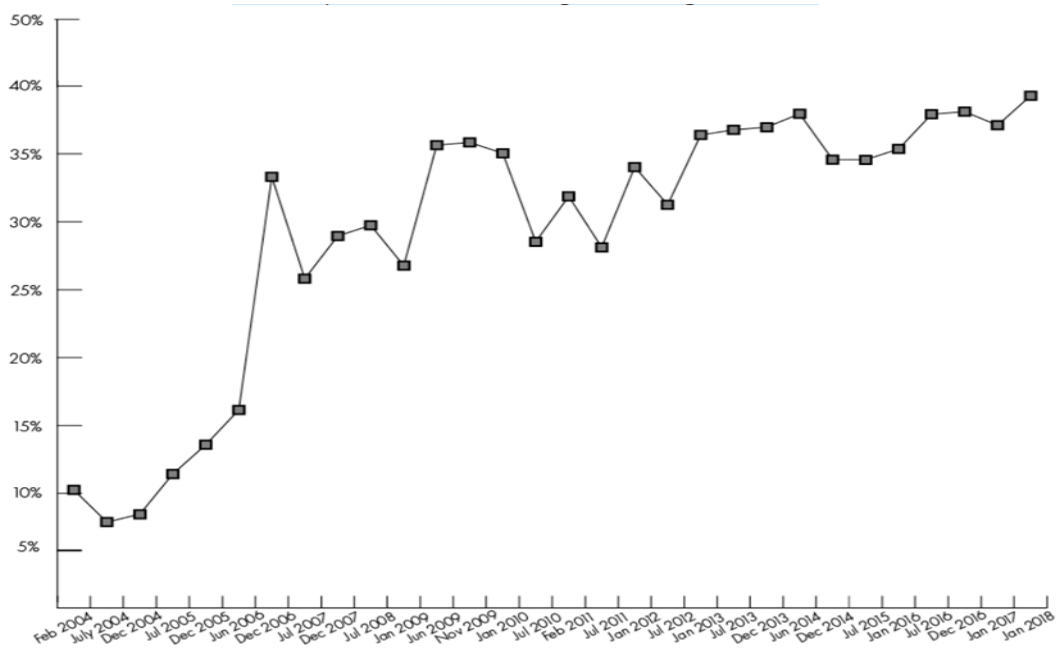

Fig. 1. U.S. Equities Off-Exchange Trading Volumes 2004-2018.

[a.] Source: Tabb Group

As the data show, OTC cryptocurrency trading volumes have been consistently increasing since 2004. Moreover, from 2006 to 2018, off-exchange trading volumes have accounted for approximately 25 to 40 percent of the market.

In fact, OTC cryptocurrency trading volumes are at least nearly double that of any other equities market (see “Fig. 2”):

Fig. 2. Comparison of U.S. Equities Market Share by Group.

[a.] Source: Tabb Group.

TABB Group's survey of OTC market participants concludes that institutional trading is expected to grow significantly in 2018, as is evident by the increasing quantity of exchanges, platforms, and technology providers that target this segment [10]. And with more regulation of the market likely to occur, the institutional money amassing on the sidelines is expected to enter the off-exchange crypto market in 2018.

Additional data provided by OTC trading companies also show a robust and growing financial climate. According to an article published by Reuters, some OTC dealers said they frequently execute greater than $100 million USD trades

every day, with ticket sizes between $75,000 and $250,000 USD [10].

V. THE CHALLENGES OF OTC CRYPTOCURRENCY TRADING

Based on our research the Challenges of OTC Cryptocurrency Trading are as follows:

- Risk of not receiving expected amount of money for the deal

Currently, OTC cryptocurrency trades are not regulated. As a result, there is no formal documentation that governs how deals between sellers and buyers are stipulated or upheld.

The documents that both parties sign are a mere formality. They don't protect the rights of altcoin sellers. In addition, they don't guarantee that the seller will receive the money for the exchange of altcoins. Because of this, there is no legal liability for either side to actually follow through with their side of the deal.

- Lack of support from banks

Regulatory, risk, and other external environmental factors that relate to the cryptocurrency market continue to evolve. As a result, major financial institutions such as banks are hesitant to accept digital currency as collateral. Sellers are put at a significant disadvantage when it is not clear when their account will be credited with the promised funds.

- Inability to make deals that exceed $10 Million SGD

Institutional investors and other high-net-worth individuals looking to move large sums of altcoins into at choose to do so with OTC cryptocurrency trading companies because it allows them to get the best deal while having little-to-no impact on the market. However, when cryptocurrency market players want to make a deal in amounts that exceed $10 million SGD, it's extremely difficult. The risk for banks skyrockets, and the time required to make the exchange increases exponentially. Moreover, there are no professional market players ready to make deals this massive on a daily basis.

- Lack of buyers' liquidity in Fiat

In general, the majority of altcoin buyers do not store or possess a generous amount of liquidity in at. To make a concrete deal, they seek a seller who is offering their desired volume of cryptocurrency for what they hold.

As a result of the difficulties of arranging a deal between altcoin sellers and altcoin buyers, the rate of at-to-cryptocurrency and cryptocurrency-to- at trades is impeded, and deals aren't being executed on a regular basis. It follows, then, that if the majority of altcoin buyers do not typically store liquidity in at, there is no option to credit the exchange.

- Unfixed timeframe for the deal

A problem that is currently plaguing the cryptocurrency market is delayed transactions. While blockchain technology should make transactions faster, as participation in the market grows and blockchains become increasingly longer, more transactions are held up waiting to be verified. Therefore, market players can miss out on favorable positions because of delayed transaction approval.

- Lack of variety of Altcoins available for the deal

Generally speaking, the aforementioned lack of support and provision of altcoin-to- at exchanges also means that banks usually don't support operations with a wide variety of altcoins. Therefore, if an institutional investor or other type of high-volume cryptocurrency market player is looking to sell their altcoins, it's very possible they would have to exchange their altcoin for another altcoin that the bank does support. This forces the seller to make more exchanges than are necessary, all the while accruing transaction fees for the seller.

- Lack of variety of Fiat available for the deal

Likewise, the aforementioned lack of support and provision of altcoin-to- at exchanges also means that banks usually don't support operations with a wide variety of at. Because banks provide limited service to cryptocurrency exchanges, they typically deal in a single currency. Again, this could necessitate more at exchanges than are necessary, all the while accruing transaction fees on the seller's part.

- Unstable demand for Altcoins

Since the advent of bitcoin transactions on January 12, 2009, when Satoshi Nakamoto famously sent computer programmer Hal Finney ten bitcoin, the demand for bitcoin and rival cryptocurrencies - altcoins such as Litecoin and Ethereum - has been largely unstable.

A novel financial innovation, speculation on the value of altcoins continues to be in ux. While many individuals, institutions, hedge funds, and others have begun to infuse confidence in cryptocurrency, just as many express hesitations about the digital currency.

This lack of uniformity among global financial investors, in addition to the fact that there is no concrete government regulation concerning digital assets in many countries of the world, fuels the instability of altcoins.

- Lack of legal transparency and reflection in books and tax accounting

At present, traditional legal transparency, accounting, and disclosure practices are still nascent in the cryptocurrency market due to its general lack of regulation. As a result, OTC cryptocurrency trading participants can put themselves in a distinctly vulnerable position when they make high-volume exchanges.

- Difficulty selling Altcoins to buyers residing in jurisdictions that deem digital assets unregistered securities

As the world comprehends the financial implications of the cryptocurrency market and the utility of altcoins, each jurisdiction continues to deliberate on whether these digital assets should be deemed registered or unregistered securities.

While some welcome a regulatory reckoning, others are cautious, and others are unequivocally opposed.

When it comes to executing altcoin-to- at trades, the laws stipulated by these jurisdictions are of preeminent importance, effectively making or breaking the possibility of a deal.

- Potential for criminal activity

When bitcoin became the main trading currency on the website The Silk Road, an online marketplace for buying and selling drugs, weapons, and other illicit goods on the so-called “dark web”, the tremendous perils of cryptocurrency trading became all too evident.

VI. CONCLUSION

Summarizing our research in the field of OTC trading in digital currency, customers expect the following from the market: Best Price Offers, Large Volumes of altcoin-to-altcoin exchanges and altcoin-to-fiat exchanges, Wide Range of Altcoins, Fast Payments and financial services 24/7, Legal Transparency, Bank Guarantees Security for large-volume deals.

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