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Bitcoin futures take crypto-currency a step forward

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Bitcoin derivatives are another step forward in the development of the virtual currency as an asset class. A Bitcoin derivatives exchange founder tells *IFLR* what's next.

There are a number of traditional Bitcoin exchanges, but there has been a comparatively smaller number of venues for trading Bitcoin derivatives.

The development of a Bitcoin derivatives market is needed to both hedge the crypto-currency's volatility and to facilitate the use of common foreign exchange products in the Bitcoin market.

Although investors want solutions, very few startups are focusing on this area, said Arthur Hayes, an ex-equity derivatives trader and chief executive officer of the Bitcoin Mercantile Exchange (BitMEX), whose beta version will go live on Monday July 28.

He noted that only one or two exchanges offer a somewhat standardised futures contract for Bitcoin. "We're trying to up the game by coming out and building a more professional platform for people to trade on," he added.

KEY TAKEAWAYS

- **The development of a Bitcoin futures market will help stabilise the currency's volatility;**
- **BitMEX, a new Bitcoin derivatives exchange, will allow traders to buy and sell Bitcoin futures contracts;**
- **But ensuring both security and liquidity will be needed for the market to grow.**

How?

BitMEX has been set up in the Seychelles. According to an Appleby note, the jurisdiction has no regulatory restrictions or prohibitions for transactions entered between a Seychelles counterparty and a foreign institution.

Hayes couldn't comment on how the Seychelles would handle a contract denominated in Bitcoin. "As far as I know, no jurisdiction globally has addressed how they would regulate a Bitcoin derivative where there was no fiat currency involved in margin, profit or loss," he added in an e-mail response.

The derivatives contracts are denominated in Bitcoin. While standardised, they do not follow the

International Swaps and Derivatives Association (Isda) Master Agreement.

The structure takes the underlying US dollar and Bitcoin exchange rate and applies a multiplier in Bitcoin. Margin, profit and loss are all denominated in Bitcoin.

To do business on the exchange, investors must buy Bitcoin and then deposit a margin to go long and short by the exchange's derivatives. It will serve as the clearinghouse for all customer trades.

BitMEX will publish documents online that explain its calculations and exchange policies for transparency.

Working with only Bitcoin removes some anti-money laundering concerns. Customers need to clear anti-money laundering and know-your-customer requirements when converting their cash into Bitcoin, and the lack of conversion on the exchange means that money can't be washed on the BitMEX platform.

Development

"Our end goal is to be where corporates, institutions and hedge funds – serious investors – will come and trade Bitcoin risk," said Hayes.

Many of those market participants are still considering their Bitcoin options. Early adopters will likely be hedge funds looking to Bitcoin, payment processers such as Bitpay and Coinbase, and retail traders who want to take more risk on Bitcoin and structure their trades differently than simply buying or selling Bitcoin.

High-frequency trading is possible on BitMEX because it has the application programming interface (API) and back-end trading assistance. Although it's easy to plug into the technology and trade, Hayes doesn't see many opportunities for high-frequency trading aside from market making.

"Unless you're going to become a market maker, I don't see many opportunities for high-frequency trading," said Hayes. Transaction costs are high, spreads are wide and commission structures are just too expensive for a traditional strategy.

More complex products will come later. Hayes predicts that the market is a long way away from the complex structures that feature in foreign exchange markets.

The futures market currently accounts for $500,000 to $1million a day, and the few options platforms available have been illiquid. The futures market must become more liquid and then optionality must be introduced across futures before more sophisticated structures can be introduced.

What's needed

The market must resolve a few issues before it grows.

The most important issue is security. Investors must be fairly confident in their understanding of Bitcoin security. Following the collapse of Bitcoin exchange Mt. Gox, there has been a renewed focus on how secure Bitcoins are and how they're being stored.

Another is liquidity. A mid-sized fund would aim to take a $10 to $20 million position in Bitcoin, but converting that much currency into Bitcoin would cause significant exchange rate fluctuations. Some exchanges that will try to amalgamate liquidity into one place so participants with large sizes can get into ecosystem.

Regulation is increasingly a concern. New York has proposed a scheme to license Bitcoins, and other jurisdictions will follow.

Hayes urged careful regulation. "Jurisdictions more forward-thinking will just let Bitcoin flourish without putting traditional banking regulations on an internet currency that, really, you can operate anywhere in the world just by having a server," he said.

He emphasised that light-touch jurisdictions will benefit. Because it's a decentralised network, where governments that try to ban Bitcoin by overregulating it will just see tax dollars move to other jurisdictions, he said.

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