



THE ETHEREUM MERGE

A Market Maker's Perspective

September 2022

F L O W ■ T R A D E R S

Introduction

Flow Traders is a market maker in over 200 crypto exchange traded products (ETPs), supports coverage of over 300 coins as part of its ETP marketing making activities, resulting in a global market share of 27% of crypto ETPs on-exchange.

Specifically, in Ethereum products, Flow Traders is market maker in 17 unique Ethereum products with a total of 62 listings, as of September 2022. As the table on page 4 demonstrates, the median YTD cash inflows (+\$1.01M) in Ethereum products is positive, even though the median YTD return is down -53.77%, illustrating that there is still demand for Ethereum products against the bearish market backdrop. This theory is further supported by the Flow Traders' crypto ETF trading desk seeing an increase in the average daily volume traded in Ethereum products.

Crypto ETPs

In addition to the increased demand for Ethereum products, institutional investors continue to see the benefits of trading crypto ETPs. Crypto ETPs are a gateway for institutional investors to gain exposure to

the underlying assets, without having to deal with custodial and regulatory issues linked to holding the underlying crypto assets on their balance sheet. Considering the performance of the underlying Ethereum price, as detailed before, it comes as no surprise that the ETPs tracking the underlying crypto assets are similarly presenting negative returns YTD. This demonstrates that the crypto ETPs are doing what they were designed to do in tracking the underlying market and are priced correctly by the market makers, see graph below.

Market Maker in Crypto ETPs

Market makers and authorized participants play an essential role in enabling the trading of crypto ETPs, as the market is reliant on their skills and expertise to provide liquidity in both the primary and the secondary market. Market makers face a range of challenges when trading crypto ETPs, including market infrastructure, liquidity and counterparty risk. Thanks to innovation and increasing rate of institutional adoption, these challenges are being tackled on a global scale.



*Source: Bloomberg Sep 2022

The Merge

A unique challenge to crypto ETPs is that of “hard forks”. Hard forks are a phenomenon that impact the underlying crypto assets that the ETP is predicated on.

A hard fork is a system upgrade or upgrade to the underlying blockchain protocol. In the case of hard forks, the new blocks created under the updated rules will no longer be accepted by nodes running the older legacy version of the software and will be rejected. This rejection creates a scenario where the two chains are no longer compatible. Historically, there have been a number of hard forks such as Bitcoin Core, Bitcoin Cash and Ethereum Classic to name a few.

While the Ethereum community has largely supported the Merge, there has been pushback given the negative impact it will have on Proof-of-Work miners. This pushback has resulted in a plan to hard fork the Ethereum blockchain and preserve a Proof-of-Work version of the network.

If this hard fork happens, the original chain is forked into two chains. The original chain transitioning to the new proof-of-stake (ETHS) and the newly forked proof-of-work (ETHW). The majority of the Ethereum community sentiment supports the Proof-of-Stake network, however a handful of investors and miners have voiced their backing for the Proof-of-Work fork. More importantly, Stable coin issuers Circle (USDC) and Tether (USDT), with a combined market cap of



*Source: Flow Traders and Deribit

In the build-up to the Merge, estimated to take place on September 15, headlines have been commenting and speculating on its effects and potential challenges. For those who have followed recent developments, Ethereum’s mainnet is set to merge with the Beacon Chain’s Proof-of-Stake system, which will mark the end of the proof-of-work Ethereum we know today and begin the next phase of Ethereum – the version that will be based on a Proof-of-Stake consensus algorithm.

\$120B, announced exclusive support for the Proof-of-Stake Ethereum. Deribit futures provide a preliminary indication of the expected price of ETHW on a spot-future basis, as depicted in the graph above. Based on this, the current market price for a ETHW token is estimated to be worth \approx \$13 as of September 2022. Another potential price indicator of the ETHW token is the ETHPOW22 contract on BitMEX, however given that this contract expires in December, additional factors need to be considered to price this product.

Name	Ticker	Class Assets (MLN USD)	Fund Assets (MLN USD)	YTD Rtn	YTD Class Flow
	Median	\$ 44.82	\$ 30.67	-53.77%	\$ 1.01
XBT PROVIDER ETHEREUM ETN – EUR	COINETHE SS	\$ 448.38	\$ 448.38	-52.01%	\$ (140.39)
CI Galaxy Ethereum ETF	ETHX/B CN	\$ 227.94	\$ 364.00	-53.60%	\$ (64.61)
XBT PROVIDER ETHEREUM ETN – SEK	COINETH SS	\$ 260.20	\$ 260.20	-50.36%	\$ (90.87)
21Shares Ethereum ETP	AETH SW	\$ 208.06	\$ 208.06	-56.25%	\$ 24.03
Purpose Ether ETF	ETHH/B CN	\$ 79.40	\$ 173.55	-53.72%	\$ 53.56
CoinShares Physical Ethereum	ETHE SW	\$ 115.41	\$ 115.41	-56.87%	\$ 35.02
3iQ CoinShares Ether ETF	ETHQ CN	\$ 81.53	\$ 81.53	-53.70%	\$ 14.49
VanEck Ethereum ETN	VEETH GR	\$ 64.54	\$ 64.54	-50.62%	\$ 12.61
ETHetc – ETC Group Physical Ethereum	ZETH GR	\$ 57.09	\$ 57.09	-50.63%	\$ (77.42)
Purpose Ether Yield ETF	ETHY/B CN	\$ 0.01	\$ 52.18	-53.97%	\$ 14.57
WisdomTree Ethereum	ETHW SW	\$ 32.55	\$ 32.55	-56.24%	\$ 11.39
Ether ETF	ETHR CN	--	\$ 28.79	-53.83%	\$ 1.36
Hashdex Nasdaq Ethereum Reference Price Fundo De Indice	ETHETI BZ	--	\$ 20.32	-58.95%	\$ 11.44
SEBA Ethereum ETP	SETH SW	\$ 8.92	\$ 8.92	-56.92%	\$ 2.13
ETF5 21Shares Ethereum ETF	EETH AU	\$ 2.19	\$ 2.19	--	\$ 5.46
21Shares S&P Risk Controlled Ethereum Index ETP	SPETH SW	\$ 1.09	\$ 1.09	--	\$ -
Iconic Physical Ethereum ETP	IETH GR	\$ 0.81	\$ 0.81	-50.77%	\$ 0.87
Global X Ethereum ETP	ETOX GR	--	\$ 0.37	--	\$ 0.11
Valour Ethereum Zero	ETHO FP	\$ 0.20	\$ 0.20	-50.76%	\$ 1.16
Cosmos Purpose Ethereum Access ETF	CPET AU	--	\$ 0.19	--	\$ -
Bitpanda Ethereum ETC	KETH GR	\$ 0.16	\$ 0.16	--	\$ 0.06
1FICAS Active Ethereum ETP	ETHB SW	\$ 0.05	\$ 0.05	-64.29%	\$ (0.29)
Helveteq Tracker Securities on Ethereum	ETH20 SW	--	--	--	\$ -
QR CME CF Ether Reference Rate Fundo De Indice	QETHI BZ	--	--	-59.57%	\$ -

*Source: Bloomberg Sept 2022

The impact of The Merge and Ethereum ETPs

Market makers face an array of challenges due the upcoming Merge. After seeing two consecutive months of positive inflows, it is essential that ETP issuers anticipate the Merge and factor in their planning that transparency is vital for market makers to accurately price products predicated upon Ethereum.

Issuers have a wide range of considerations they need to take into account before the Merge occurs. Most issuers have announced the halt of creation and redemption mechanisms at T-2 before the Merge is set to take place. The underlying crypto leg of the ETP therefore has to be settled T-1 before the Merge to avoid settlement discrepancies. This is to ensure that the issuer and the market maker are not exposed to potential side-effects of the Merge.

Another consideration is the custody aspect of the tokens. If there is a hard fork, the custodian of the Ethereum token needs to support the airdrop of the ETHW (Proof-of-Work) tokens.

As outlined above, market makers require continued transparency to accurately price products that contain Ethereum as an underlying asset during the Merge. Options for issuers with regards to the hard forked tokens can include accruing both the ETHS and forked

ETHW as underlying for their issued ETPs NAV or issue a new ETH Proof-of-Work product. Another avenue would be to sell the forked ETHW tokens on the primary markets. If the issuer were to choose the latter, they could either pass on the value of the sale to the holders of their ETP or alternatively keep it in their own treasury.

Concluding remarks

This Merge has revealed challenges and highlighted differing perspectives and roles in the digital asset space. We believe that we are truly at a pivotal moment in Ethereum's history.

Therefore, in order to ensure that the ETPs track the underlying Ethereum market leading up to the Merge, it will be important to have transparency across the various participants in terms of their treatment of the two chains.

Market makers will fulfill their duty as a backstop of liquidity, no matter what. Greater transparency contributes to a stronger, fairer market and enables accurate pricing.

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