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Virtual Event Series

The Future of Digital Asset Brokers

Guest Speaker:

Fernando Martínez Fernández
CEO
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Hosts:

Kenny Estes
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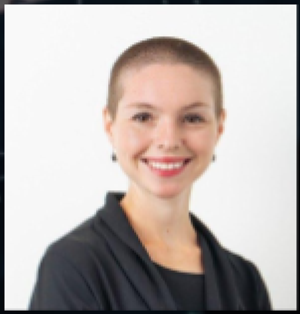

Ayla Kremb
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Diffuse

DiffuseTap: The Future of Digital Asset Brokers

Last time on DiffuseTap, Fernando Martínez Fernández, CEO of Nonco, talked to us about the role of a digital asset broker, what the most recent Binance case means for the industry, and why crypto might still be too complicated for the average individual.

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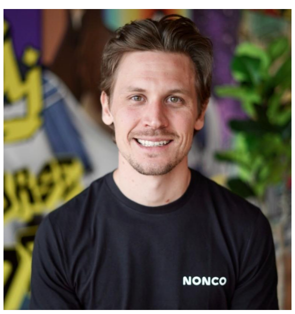
DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas)… straight from your armchair like a boss.

Meet the Speaker



FERNANDO MARTÍNEZ FERNÁNDEZ is the CEO of Nonco, an innovative brokerage firm that provides institutional digital asset brokerage through a unique non-custodial approach that leverages clearing, smart contracts, and bilateral settlement capabilities. Prior to joining Nonco, he served as Managing Director of OSL, the largest digital asset platform in Asia.

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KENNY ESTES: Let's hear from the speaker du jour. Fernando, do you want to tell the folks a little bit about your background and what you're up to over at Nonco?

FERNANDO MARTINEZ: All right. Thanks, Kenny. And thank you everybody for joining this call. A little bit about myself. I've been in crypto for roughly 10 years. Prior to that, I have my own commodities trading desk in Mexico. Nonco is a spinoff from OSL, a pretty big Asia-focused player in the digital asset space.

It was the first one to be listed on the Hong Kong Stock Exchange focused on crypto. It was the first one to receive the Securities and Futures Commission license. First one to be audited by PwC, and the second one in the world to receive a fully-insured crime and specie insurance for digital assets. I lived in Hong Kong from 2014 to 2019. That's where I stepped into crypto. In 2019, they shipped us over to the Americas where I started the region alongside my team.

From 2019 to 2022, we grew the Americas region, which is the US, Mexico, Argentina, Brazil and Colombia. At one point, the Americas became more than 50% of our sales global volume and revenue. After seeing such huge, huge success from part of the team, we decided to spin off, but we spun off doing it in a very amicable fashion. We sought their support.

The support was the following: that they would exit the Americas region, and they would contribute to us 400 institutional and corporate accounts in order for us to create Nonco and give them a share of the company.

From there, we did a financing round where we have people like Valor Capital. They put Brian Brooks, the US controller. He is on the part of the Board of Directors. We have Hack VC, which comes with Alex Pack. We also have Morgan Creek and a bunch of others invested in us. We launched in April and since then, we've been scaling our operations month to month.

So far, we've executed about $6 billion for institutional and corporate counterparts, and we do it across four different products: Spot liquidity, derivatives, structured products, and funding. That's it, enough about us. I'm happy to dive into the conversation.

KENNY: Alright, let's start really high level, Fernando. What does a digital asset broker do?

FERNANDO: All right. So first of all, we need to provide a decent price for our counterparties. There are different types of brokers. First is going to be the broker that literally puts the buyer and the seller together in futures, like Paradigm. This is very common. Then, you have the dealers and you have your principal trading desk that offers liquidity services. There is a little bit of a mix and match here because not everybody understands the capabilities for brokers or OTC dealers when it comes to price strategies on this.

For example, if you talk about big, big brokers like FalconX, whatever they do, they aggregate all of the orders. We love them. They take everybody's prices, and they aggregate it, and then they show that to their own counterpart.

However, when it comes to pricing, what happens a lot of the time is that when you are providing liquidity on a principal basis, that type of flow becomes very, very toxic. Even if the aggregators have all of the venues alive for them, they're not necessarily going to have the best price. When you're pricing on a principal basis, you are able to scale your prices based on the assets that you have. And ultimately, your counterparts will have better prices every now and then.

KENNY: Okay. So, if you're acting as a principal, you can get better pricing. So then, is Nonco acting as a principal as well on the broker side?

FERNANDO: Yes, we are acting as a principal as well. A little bit about ourselves that is different from Cumberland is that we do not have any other prop strategies. What do we do? We warehouse the risk of the client. We have our client book, and that client book tries to aggregate all of the orders from the client flow and whatever delta is there. Then, we take it to the exchanges.

But here, where the magic happens is we know the sensitivity of the client. Let's say that an asset manager comes in. We know that he likes to trade 10 basis points, so we are going to give him that. And then, we may take a loss on that order. That's where the principles side of the business comes into play.

Obviously, it's our job to make sure that we don't warehouse too much risk and we manage our risk accordingly to make sure that we are able to crystallize the spread, or gain a better profit from that trade.

KENNY: Understood. So in traditional finance terms, dark pool is basically how you're acting, right? That totally makes sense. So, in general, how has the broker's scope changed in the last, say, two years post FTX? How has the business changed and developed for better or worse?

FERNANDO: Yeah, that's a great question. I think obviously, the biggest risk that all OTCs have is counterparty risk. You can never take counterparty risk too seriously. It's very, very, very important. Prior to FTX, everybody was settling bilaterally. It was like, “Okay, I'll trade with you. We trade on a DVP perspective. Everybody has their NOP limit, and you have 24 hours to settle.”

Why? Because if you're an OTC dealer and you're not a custodian, you can add cost to the client's assets. But here, the problem comes down to what if the client fails to settle? What if the mark to market of that trade is just way underwater?

What we do at Nonco is we manage that risk really tightly. Every single client has three different types of limits. First is going to be the NOP. Let's say you have up to a million dollars outstanding position that you can trade with us. From there, we have mark to market limits according to the asset. You're trading stable coins almost one to one, so the volatility is not big. You also have things like Bitcoin and Ether. But if you're trading ARB or Solana or XRP, or any of those higher beta assets, the mark to market limits are going to be way smaller.

And then, the third one is time. You need to settle within 24 hours. If you start to settle after that, then you are basically up for financing. Those are the limits. But from there, we started seeing that the settlement risk was huge, because people still defaulted. In my almost decade-long OTC dealer experience, we haven't had a lot of those cases. But when you do, you want to mitigate them as much as possible.

But also, you want to give your counterparty or your client the ability for them to manage their counterparties more efficiently. So, what we did here is we tried to move into more of a centrally-cleared model, just like TradFi. You're dealing with your broker. You're dealing with an OTC firm. Why do I have to settle with you?

Then, you go into a pissing fight of how big your balance sheet is, how many licenses you have, what jurisdictions you operate with, etc. And even though all of that is great, we saw firms like Genesis trading go under. You can never be too safe. So, what we opted to do here is to move to the operational side. Here, you can fiddle with us through three different ways, and we've seen the rest of the industry start to migrate like us.

First one is bilateral fine. Second one is through clearing venues. In clearing venues right now, you have Standard Chartered, and you have Cboe Digital. Cboe rolled out their clearing facilities about three months ago.

KENNY: That's the Chicago Board Options Exchange, for people who don't know the acronyms.

FERNANDO: Yeah. I think we actually did the first trade about two months ago where we traded with DV Chain, which is also a Chicago and Canadian-based firm. We cleared on CBOE Digital. That was fantastic because there are counterparty risks against Cboe, but not DV Chain.

You also have Gemini. Gemini was the first one that started doing this. Funnily enough, in 2021 and 2022, where a lot of the ETFs got started getting approved both in Canada and in Latin America, specifically in Brazil, a bunch of them asked you to clear through Gemini. But we didn't really see this pick up until post FTX. You had peer tokens and so on. And now, you have these venues.

And then, the third option that we're seeing up and coming is settlement on-chain. So, instead of me having the counterparty risk with my trading counterpart or the clearing venue, you can also settle on-chain. You can create a smart contract using Membrane or Fireblocks, which actually rolled their smart contract settlement just yesterday, where your counterparty risk will be against the smart contract.

Why is this important? Even though we believe clearing venues are the future, they're going to be the future just for certain specific types of clients. Not everybody. All the crypto natives still do a bunch of things on-chain.

And when we saw the banking crisis as Silvergate, SVB, and Signature went down, every single human being that was trading crypto was settling with stable coins. That is why we believe that also offering these smart contract settlements allows your counterparties or our counterparties to mitigate counterparty risk as much as possible.

I think counterparty risks are the biggest highlight. Obviously, this is not the first time. History always repeats itself. The first time that we saw a big hit on crypto, which not many people know of, was back in 2018 when Ether went from $1,400 to $400, and then $80. There was a big Japanese firm that everybody took a loss against.

I'll take another example. A big fund from the US that I already mentioned previously. In order for us to increase our activity with them, we need to settle through Anchorage. They don;t want to have the counterparty risks with us, and we believe that that is the responsible way to go.

KENNY: All right. So generally, with clearing there are three options. Bilateral, which is just directly with each other, and you have to deal with each other's risk and balance sheet risk. Then, there's centralized, which is basically how most traditional finance works, where you have a central party that is generally over collateralized.

And then, the new one is on-chain, where I presume that the cash you're going to use to buy the assets that the broker is selling you actually goes into the smart contract in advance. And then when they deliver, it comes out, and then there's no counterparty risk. However, there is smart contract risk. That is a different type of risk, but it's a pretty simple contract, honestly. It's not unhackable, but it's pretty solid. That's interesting.

Generally, the theme I'm picking up here is counterparty, counterparty, counterparty, which is fair. So, what do you think about Binance? I heard some news recently.

FERNANDO: Yeah. So ultimately, I think that the news we saw in the last seven days is extremely positive. Positive for the industry. Positive that CZ pleaded guilty. It's good. It could have come way worse. Prior to the events of these last seven days, we saw Binance as a huge, huge risk. Not only from everything that was happening with the SEC, CFTC, and the Department of Justice against Binance, but also from an AML perspective. There were a lot of firms that did not want to take that risk. There were just too many uncertainties. We've seen it in the past many times.

However, what I believe will happen to Binance, and hopefully this is not the case, is that it's going to be a repeat of what happened with BitMEX, when Arthur Hayes got sued by the SEC. Right after that, we saw that they lost all of their market share. Eventually, within a couple of months, their market share started decreasing. And right now, they are not even part of the map anymore. We believe that with Binance, that is going to be the case as well.

Why? Again, even though they already pleaded guilty, even though hopefully they settled, it doesn't matter if CZ goes to jail or not. Ultimately, there will be better second options we are seeing right now. For example, Coinbase is obviously one of the winners in the US. We have Kraken, which is under a little bit of stress. They don't have enough liquidity to come out as a winner in my perspective.

But we're also seeing newer alternatives like ICAP which is offering spot, or even Coinbase international, which will start offering derivatives. There will be these newer alternatives that will allow users to feel more comfortable with who they are. Let's take for example CBOE Digital. And again, I don't need to sell them, but I think that their whole structure is very, very much how all of this structure should be. For CBOE Digital, they custody their assets in Bitcoin.

So, if you have your assets there, your assets are not going to be solely at their discretion to see if they do a good job or not. They utilize BitGo, and that's fantastic. You can also clear or you can leverage other alternatives to access them. That is one thing that Binance didn't have, for example. And if we want to take another relatively unregulated derivatives exchange, even OKX is doing a much better job of addressing the counterparty risk that they pose towards their clients.

Another example is if you access Fidelity, they allow you to mirror your own assets that you have with them, and you can trade with OKX, so that's fantastic. My counterparty risk is not going to be against OKX. I can still access their liquidity. I can still access their products. but I will be warehousing my assets in Fidelity, and that is a responsible way of looking at it.

I don't see how Binance is going to be shifting towards this model. They still have a bunch of outstanding things that they need to settle. I think with Binance, even though we believe they’re great and they have a great product, there are just too many negative things on the baggage that they need to take responsibility for, in order for people to continue trading with them.

KENNY: Fascinating. And now, there's this new wave of exchanges, Cube being a good example, that are massively oversubscribed by the Sequoias of the world. The users are actually maintaining the assets themselves through an MPC wallet, so there's no chance of the exchange rehypothecating and buying naming rights to stadiums for unknown reasons with that money. On the other hand, the users are still able to transact in a reasonably centralized and efficient manner. What are your thoughts on this new style of exchanges?

FERNANDO: I think they're great. I love crypto. Yes, let's decentralize everything. Everybody needs to have power over their assets. However, the reality is that that's too complicated, even for the individual user. Having your own MPC, making sure that you have the seed, and you have the correct processes in place – it's a huge pain in the butt. Imagine being an institutional player. How the hell are you going to get your boss to sign off on you having your own MPC if you don't have the process? I think that there's still a lot of friction, even though it is the future.

Making everything decentralized, and making sure that everybody holds the assets – I think that is a lot of responsibility that not everybody is willing to have. Ultimately, I do believe in the segregation of duties. The Fidelitys, the BitGos, the Anchorages, the Standard Chartered, etc., all of those guys play an important role to custody the assets. And then, you have your own exchanges, just like the traditional model.

I still think that the whole decentralization aspect has a lot of friction, and I don't foresee in the immediate future that people will start to use it more. I'll give an example. Dydx is fantastic, with their decentralized perpetuals. Cool. But it's hard to trade there. It's not that easy.

Now, imagine you're in Coinfund or Goldman Sachs; you have to be very, very sophisticated. Your risk controllers will need to allow you to do so, and your risk committee to allow you to do so. It's just too much friction. I still believe that people want easy, secure, and regulated access.

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Corporate Director, CME Group

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VP/Global Head of Tax, Binance.US

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