

Stablecoin Safety Assessment

Coin	First Digital USD (FDUSD)
Date	30-09-2023
Overall Grade	C

Factor Scores:

S. No	Factor	Score	Assessment
1	Stability	0.73	Moderately stable
2	Management	0.88	Very low risk
3	Implementation	N/A	Not assessed
4	Decentralization	0.25	High risk (Not relevant to the grade)
5	Governance	0.40	Moderate risk
6	Externals	N/A	Not assessed

Summary

- FDUSD is a stablecoin issued by First Digital Labs, which is a part of Hong Kong-based First Digital Group.
- First Digital Labs is not a regulated issuer of stablecoins or digital assets.
- FDUSD is backed by USD cash deposits (79%) and US T-Bills (20%) with a maturity of less than 3 months. These assets are held by banks and custodians in Hong Kong, Switzerland, and Australia.
- Although the reserves are held in custody by a Hong-Kong trust, we believe these reserves are not bankruptcy-remote. In the event of bankruptcy of the issuer or its holding company, customers' funds may not be isolated from the liquidation process.
- FDUSD meets the bare minimum requirements to achieve a passing grade.
- At present, FDUSD lacks meaningful utility and is appropriate for those who wish to benefit from Binance's Zero Trading Fee promotion on the BTC/FDUSD pair. For all other users, safer and/or more liquid alternatives exist.

FDUSD's rating can be improved to a B- by:

- Being regulated by the Hong Kong Monetary Authority for the issuance and management of stablecoins.

Evaluation

1. Stability

[Score 0.73]

1.1. Reserves

[Score 0.72]

1.1.1. Collateralization % and Type of Collateral

[Score 0.95]

As of August 31, 2023, FDUSD is predominantly backed by cash deposits (79%) and short-dated US T-Bills (20%) in segregated accounts.

A significant portion of FDUSD reserves is held as cash deposits. This is a concern as First Digital Labs does not disclose the names of the banks holding cash and we have no way to ascertain the financial strength of these banks, nor do we know if these deposits are insured against a bank default. Even if unlikely, a bank collapse could result in FDUSD becoming significantly undercollateralized.

Bluechip has made several attempts to seek more information from First Digital Labs but we are yet to receive a response.

1.1.2. Storage of Assets

[Score 0.70]

For off-chain collateral, we rank storage methods as follows (highest to lowest)

- With regulated custodians in reputable jurisdictions
- With regulated custodians not in reputable jurisdictions (e.g, BVI, Bahamas)
- Others / Undisclosed

FDUSD's reserves are held at regulated banks/financial institutions in Switzerland, Hong Kong, and Australia. However, without knowing the identities of these institutions, we have no way to assess their financial strength.

1.1.3. Asset Segregation

[Score 0.50]

FDUSD reserves are held in segregated bank accounts held in the name of First Digital Labs through a custodian, First Digital Trust (a Hong Kong-registered trust service provider, and related entity).

Although the reserve assets held by the trust are segregated from the trust service provider's assets and protected from its bankruptcy, the reserve assets may not be protected from the bankruptcy of the issuer or its holding company.

We draw attention to the following clauses from FDUSD's Terms of Service:

Clause 3.8 – “FDD¹ Reserves are owned beneficially by FD121. While FD121² may hold the FDD Reserves in interest-bearing accounts or other yield-generating instruments, you acknowledge that you are not entitled, whether by way of contract, trust or otherwise, to such assets or any interest or other returns whatsoever earned by FD121 or its custodian on FDD Reserves. As set out in Section 2 above, FDD is backed by an equivalent amount of assets held by FD121. For each FDD issued by FD121 and remaining in circulation, FD121 will hold either one Dollar or an equivalent amount of assets denominated in either USD or the currency in which the FDD is denominated in.”

Clause 3.9 – “FDD does not itself generate any profits, income, interests, payments or returns for holders of FDD and only represents your right to sell FDD for an equivalent amount of fiat currency which the FDD is denominated in through your account with FD121.”

The language used in the clauses above suggests that FDUSD reserves are not held for the benefit of FDUSD holders, but for the benefit of First Digital Labs (FD121). This is further corroborated by the FDUSD Reserves attestation report issued by Prescient Assurance.

According to their report “*This Reserve Accounts Report refers to the account held and managed by a related party, being a public trust company registered in Hong Kong and a custodian for the Company (the “Custodian”, and the account being the “Custody Account”). The USD balance is custodied in the Custody Account for the benefit of the Company. In addition to the Custody Account, the Custodian has opened distinct accounts with separate institutions held under the Custodian’s name for the benefit of the Company”.*

In our opinion, in the event of a liquidation process arising from insolvency of First Digital Labs or its holding company, the FDUSD reserves will likely not be isolated from other assets subject to liquidation and FDUSD holders would be treated as ordinary creditors of First Digital Labs.

We also believe that First Digital Labs’ use of a trust structure for custody of FDUSD reserves only protects the FDUSD reserves from the bankruptcy of First Digital Trust, the entity providing trust services, for the benefit of First Digital Labs. Therefore, we do not believe FDUSD is bankruptcy-remote from the perspective of FDUSD holders. Bluechip has reached out to First Digital Labs to seek information for justification of their claims but we are yet to receive a response.

¹ FDUSD is referred to as FDD in First Digital Labs' legal terms.

² First Digital Labs is referred to as FD121 in First Digital Labs' legal terms.

1.2. <u>Market Feedback</u> *	[Score 0.70]
1.2.1. Frequency of Deviation Below Peg	[Score 0.70]
Number of Days where VWAP < Peg by 0.5% or more during the past 180 days = 0	
1.2.2. Max Deviation Below Peg	[Score 0.70]
Biggest daily VWAP deviation below peg: 0.11%	
1.2.3. Volatility (% per day)	[Score 0.70]
Daily volatility (%) over the past 180-day period: 0.05%	
1.2.4. Downside Volatility in a Market Downturn	[Score 0.70]
Average deviation below peg during the 5 worst-performing days for BTC (DoD price change) in a 180-day period: 0.05%	
Score restricted to 70% of maximum possible score as FDUSD has been in existence for less than 180 days.	
1.2.5. Liquidity Pool Imbalance	[Score N/A]
Not assessed since on-chain liquidity is immaterial.	
1.3. Stability Mechanism	[Score 0.75]
1.3.1. Core Mechanism	[Score 1.00]
FDUSD relies on market participants to arbitrage differences between the market price of FDUSD and the net asset value of each FDUSD (typically, 1 USD if FDUSD is fully-collateralized). We believe this is the most effective price stability mechanism.	
When FDUSD trades away from its peg, any user who has a KYC'd account with First Digital Labs can mint or redeem FDUSD for US Dollars and make an instant profit. This risk-less profit opportunity attracts more participants and eventually pushes the market price of FDUSD towards its peg.	
1.3.2. Primary Liquidity Access	[Score 0.50]
First Digital Labs claims only institutional users from supported jurisdictions can redeem FDUSD for US Dollars. Retail users must rely on liquidity in secondary markets.	

- 2. Management** [Score 0.88]
- 2.1. Restrictions** [Score 0.88]
- 2.1.1. Known Core Teams** [Score 1.00]
- First Digital Labs is led by Vincent Chok, the CEO of First Digital Trust and Gunnar Jaerv, COO of First Digital Trust. Chok previously founded and led Legacy Trust Company, a Hong Kong trust services company, while Jaerv headed the digital assets division.
- 2.1.2. Jurisdiction Score** [Score 0.76]
- Our jurisdiction scores are derived from the World Justice Project’s Rule of Law (RoL) Index – which ranks countries. We specifically consider the index’s factors ‘Regulatory Enforcement’ and ‘Civil Justice’.
- First Digital Labs is headquartered in Hong Kong.
- 2.2. Track Record**
- 2.2.1. Team’s Background** [Score N/A]
- Not scored
- 3. Decentralization** [Score 0.25]
- 3.1. Regulatory Oversight** [Score 0.25]
- Regulatory oversight increases the risk of censoring endpoints of the stablecoin's network (such as the issuer, banks, and custodians) as well as users. A score of 0 indicates a high degree of government censorship risk.
- First Digital Labs is not regulated, but it has banking relationships with regulated banks in Hong Kong and Switzerland.
- Note: Censorship resistance is not a key objective common to all stablecoins. Consequently, a low score may not be a relevant source of concern to most stablecoin users. Furthermore, regulatory oversight can also be beneficial to some users as it entails more robust consumer protection mechanisms and increased transparency.
- 3.2. Custodian Risk** [Score 1.00]
- When evaluating custodian risk (i.e, credit risk of entities holding assets), we consider the distribution of assets between entities that hold the assets, such as the issuer, their banks, and custodians.

First Digital Labs holds its reserves in 4 institutions (a bank and custodian in Hong Kong, a bank in Australia and Switzerland).

3.3. Type of Collateral

[Score 0.00]

When evaluating decentralization, it is important to consider the extent to which the stablecoin's value is tied to a central authority or external fiat currency. Monetary policies / decisions taken by such authorities / central banks can have an impact on the purchasing power of the collateral.

FDUSD is fully backed by USD-denominated real-world assets which are subject to the monetary policies of the United States.

(Fiat currencies earn a score of 0 and decentralized cryptocurrencies earn a score of 1)

Note: Independence from a nation's monetary policies is not a key objective common to all stablecoins. Consequently, a low score may not be a relevant source of concern to most stablecoin users.

3.4. Decision Making & Voting Power

[Score 0.00]

Fiat-backed stablecoins such as FDUSD are run by private corporations. As such, the absence of decentralized decision making and voting power is a feature, not a bug.

3.5. User Blacklisting

[Score 0.00]

First Digital Labs can blacklist specific user wallets.

Note: Censorship through blacklisting helps prevent legitimate users from transacting with criminals. This is particularly relevant to institutional users who are obligated to report their transactions and activities.

4. Governance

[Score 0.40]

4.1. Holder Protection

[Score 0.00]

FDUSD is an unregulated instrument. It is not subject to regulatory/ external oversight mechanisms, and regulations/guidelines that impose prudential limitations on what an issuer can do. Unlike most other issuers of fiat backed stablecoins which are either regulated as a stablecoin issuer, money transmitter or payment institution, First Digital Labs is none of those. It has full discretion over its own governance, operations, and treasury management.

At present, holders of FDUSD solely rely on contractual protections arising from FDUSD's terms of service, which holders have no power to negotiate.

4.2. Periodic Reserves Attestations

[Score 1.00]

Our rating considers the type & frequency of reserves attestations.

Type [Score 1.00]

Attestations can be broadly classified into 2 categories based on the nature of the auditor's report. – 'Assurance Engagements' and 'Agreed Upon Procedures'.

Assurance Engagements are similar to audits in that the auditor determines the nature and extent of work required to express an independent opinion (provide assurance) on a particular matter. The auditor is free to conduct as deep an examination as they may deem appropriate to arrive at a reasonable conclusion. Assurance Engagements require the auditor to stake their reputation, and therefore carry more weight. Assurance Engagements provide either a 'reasonable level of assurance' (also called examinations) or a 'limited level of assurance' (also called reviews). The former is better and offers the same level of assurance that is provided in a full-fledged financial audit but with a comparatively smaller scope and subject matter.

Agreed Upon Procedures are engagements wherein the auditor is engaged by the issuer to perform specific tasks and report on factual findings. The auditor's scope of work is limited by the issuer and does not involve expressing an opinion. Instead, the auditor provides factual statements in his or her report and the users of such reports are expected to form their own opinions on the matter. In such cases, the auditor does not stake their reputation and provide an assurance of any sort. AUPs, while useful, are inferior to Assurance Engagements.

Frequency [Score 1.00]

Reserves attestations can be monthly, quarterly, half-yearly or annually.

Since review procedures are performed on reserves data as of a particular day (typically, last day of the quarter), they do not consider transactions and events which occur in between reporting dates. Consequently, periodic reserves attestations provide a lower degree of assurance compared to a full scope financial audit.

First Digital Labs has engaged Prescient Assurance, a US-based accounting firm, to provide monthly assurance opinions on its reserves.

4.3. Financial Audits

[Score NA]

Periodic Reserves Attestations alone are inadequate to ascertain the existence and adequacy of reserves, they need to be complemented by full scope annual financial audits.

As a recently incorporated entity that is yet to complete a full year of operations, First Digital Labs' financial statements are unlikely to have been audited yet.

4.4. Redemption Policy

[Score 0.00]

Our scoring reflects whether stablecoin issuers have reasonable and transparent timelines for processing redemptions.

FDUSD's terms of service do not provide redemption timelines.