UNDER THE SPOTLIGHT:

Staking in crypto ETPs

Simplifying Staking

21Shares

Staking and lending: Understanding crypto's nuances

Tom Eckett, Editor, ETF Stream

JUNE 2023

Sponsored by:

21shares™

State of Crypto

In this issue: **Inside Crypto Exchange-Traded Products**

21shares™

Simplifying Staking

How a longstanding feature of the blockchain ecosystem has entered the ETP space

Crypto exchange-traded products (ETPs) continue to gain popularity with the market seeing a 35% growth in net new assets in 2023 compared to 2022. Given this continuous growth, it is important for those interested in entering the asset class to understand how some of the more sophisticated mechanisms behind certain ETPs work – like staking.

Staking is a feature of proof-of-stake (PoS) networks, like Ethereum, Binance Coin, Cardano, Cosmos, Polkadot, Solana and Tezos that has grown in popularity recently due to its sizable return potential.

Staking exists to protect the security of crypto networks by incentivizing crypto holders to lock up a portion of their assets for a period of time in order to validate and confirm blocks – in exchange for earning rewards. The practice enables investors to earn passive income on their investments, in the form of native tokens, in return for committing some of their crypto capital to attest that a block of transactions is valid as a safeguard against fraud.

In recent years, select crypto ETP providers have introduced staking into certain products – allowing ETP holders to earn greater returns.

Let's review the benefits and risks around staking – and why the way investors access staking matters.

Benefits of staking

- Earn passive staking yield: Returns are generated through both transaction fees and token issuance. Investors who enter products that engage in staking not only benefit from the performance of their ETP, but can also add additional passive returns on top of price growth.

- Contribute positively to Proof-of-Stake (PoS) networks: Investors who engage in staking are helping to support PoS networks by validating them. It is important to support PoS networks because they have numerous advantages such as requiring less energy consumption, lower barriers to entry and reduced centralization risk.

Risks of staking

- Waiting period: Before staking, it is important to note that most cryptos impose a waiting period where staked assets are locked up. Investors must be comfortable with this waiting period – or should access staking through providers like 21Shares, who hold a portion of their assets unstaked, so that daily redemptions are possible if investors want to sell.

- Slashing: In staking, if an error occurs when trying to confirm a transaction, it is called "slashing" and means some of the staking rewards are lost as a result. In order to mitigate this risk, it is safest to access staking through a provider that employs professional staking platforms that focus on staking all day, every day.

Accessing staking via ETPs

Accessing staking via ETPs versus staking pools provides many benefits and safety precautions – similar to how accessing crypto via ETPs versus buying directly provides security and upsides. When staking through a crypto ETP, investors maintain full control and custody of the underlying assets, which are allocated to the validators for staking purposes only. Additionally, earned staking rewards are reinvested into the ETP, which adds to the ETP's performance.

As crypto ETPs continue to gain popularity, the demand for reliable and safe ways to access staking grows too. Staking is a long-standing feature of the blockchain ecosystem and offers one of the most attractive potential return streams available in the crypto ecosystem. While the return fluctuates, it averages around 7%. With this return potential, it is no wonder investors are starting to get curious about staking – and we expect this to become a more mainstream practice in the years to come.

Staking and lending: Understanding crypto's nuances

Maturing market

Author: Tom Eckett

Securities lending is a well understood aspect of the ETF market, however, the ecosystem of earning passive income via lending and staking is only starting to mature in the crypto space, especially within exchange-traded products (ETPs).

Within ETFs, the process is a relatively straightforward one where an issuer loans out the underlying securities of an ETF in exchange for collateral and a small fee.

Despite the practice being almost second nature to the market today, it should not be underestimated the role it has in enabling short-selling, facilitating the clearance of failed trades and providing liquidity to market makers.

In the crypto space, the practice of lending is relatively similar with the issuer receiving a fee for loaning their assets to a borrower, all of which is facilitated by a third party.

This process provides investors with a source of passive income but there can be counterparty risk, especially when market liquidity dries up.

21Shares is the only ETP issuer that has the ability to engage in crypto lending via two products, the 21Shares Bitcoin Core ETP (CBTC) and the 21Shares Ethereum Core ETP (CETH).

Along with lending, staking is the other method investors can earn passive income when investing in certain crypto ETPs. 21Shares summaries the process neatly:

"Staking allows crypto owners to earn passive income by contributing to the process of confirming that transactions on the blockchain are valid. Blockchains use several different mechanisms to confirm transactions are valid. The proof of stake (PoS) method requires validators to put up ('stake') tokens as a guarantee that the transactions they are adding to the blockchain are legitimate. The more tokens a validator contributes, the greater the likelihood that they will be selected to validate the transaction, earning a reward for doing so."

It is important to note staking is only a feature of PoS networks meaning cryptos such as bitcoin that use a system called proof of work (PoW) do not offer rewards for staking.

21Shares became the first issuer to launch a staked crypto ETP, the 21Shares Solana Staking ETP (ASOL), in June 2021 and has since brought the 21Shares Tezos Staking ETP (AXTZ) to market as well. According to data from Staking Rewards, solana is currently yielding 6.3% and tezos is yielding 5.4%, as at 15 May.

Like with any yield-earning practice, staking does not come without its risks, the main being a lack of liquidity due to lock-up periods. Polkadot, for example, requires staked coins to be locked up for 28 days which means there is a risk an issuer may not be able to satisfy investor demand until the period is over.

However, the process of staking plays a crucial role in strengthening the entire crypto ecosystem by enabling investors to participate in the security of PoS networks. This robustness is what the crypto market needs if it is to thrive over the next few years.

Tom Eckett is editor of ETF Stream