

DIGITAL ASSETS /

# Regulatory Actions Highlight Risks But Market Remains Bullish

DeFi, exchange tokens & off-shore ICOs offer risks, but DOJ news is net positive, and Square's \$50M BTC bet shows larger opportunity

A slew of regulatory announcements hit the crypto markets over the past week and a half. Actions unsurprisingly indicate US and global regulators are committed to stomping out illicit activity, securities violations, money laundering, price manipulation, and non-compliance with banking regulations. On balance, we view recent news as a positive for crypto markets, despite select smaller pockets of risk, and we believe the prevailing bull market trend is intact.

- **Global Regulators Cleaning Up Crypto Bad Actors.** On October 1st, the US Department of Justice and CFTC charged crypto derivatives exchange BitMEX with operating an unregistered trading platform and violating the Bank Secrecy Act. [\(Slide 4\)](#) Soon after, the SEC filed suit against infamous crypto investor John McAfee for ICO promotion and tax evasion. The same week, the UK's FCA announced a sweeping ban of retail focused crypto derivatives products, which will go into affect January 2021. Finally, yesterday the DOJ issued a cryptocurrency enforcement framework indicating areas where they see "legitimate" and "illegitimate" activity.
- **Bull Market Sentiment Outweighing Enforcements Actions.** Bitcoin has shown strong resiliency in the face of what could be viewed as major regulatory headwinds. [\(Slide 2\)](#) We see the market's willingness to focus on positive Square news and ability to push past \$11,000 as a sign that current actions are less likely to kill the rally than Trump's prior assault on crypto during 2019.
- **Interviewed Key Opinion Leaders See BitMEX Debacle As Net Positive.** We've interviewed industry thought-leaders across the legal, indexing, capital markets, and active management segments of the industry. [\(Slide 7\)](#) Overall, we believe the prevailing view is that recent actions are significant but cleaning up crypto is a positive for markets long term. The BitMEX news was no surprise to those paying attention. [\(Slide 8\)](#) Market impact was minimized since the exchange's dominance has been on the decline since the March Black Thursday sell off. [\(Slide 10\)](#) Investors believe a transition away from BitMEX's high leverage BTC denominated products will reduce market volatility and overall risk. [\(Slide 11\)](#) Additionally, stricter exchange enforcements and oversight should take us closer to a Bitcoin ETF. [\(Slide 12\)](#)
- **DeFi, Exchange Tokens & Non-U.S. Listed ICO's Offer Risks Worth Watching.** We do see select crypto market segments as more exposed to regulatory risks than others and are worth watching closely. DeFi projects have come under pressure for lacking KYC/AML. We see off-shore quasi-equity exchange tokens as an area of risk that investors may be under appreciating as some have had a history of compliance allegations. [\(Slide 15\)](#) Should risks similar to BitMEX emerge, it would materially harm their token value. We see further risks with crypto tokens exclusively listed on off-shore exchanges where stricter U.S. investor prohibitions could limit liquidity and demand.
- **Are Investors Properly Pricing Binance (BNB) Token Opportunities & Risks?** Binance's current P/E ratio is in line with the major US exchanges the NYSE, CBOE, CME, and Nasdaq. [\(Slide 17\)](#) While Binance could capture a share of BitMEX's lost volume in the near term, the exchange has been accused of several regulatory challenges and it's worth diligently considering if risks associated with the token are properly priced. [\(Slide 16\)](#)

Bottom Line: we view recent regulatory announcements as positives for the broader crypto market. While area of concentrated risk should be evaluated closely, the macro long term trend remains bullish in our view.

Digital Assets Strategy

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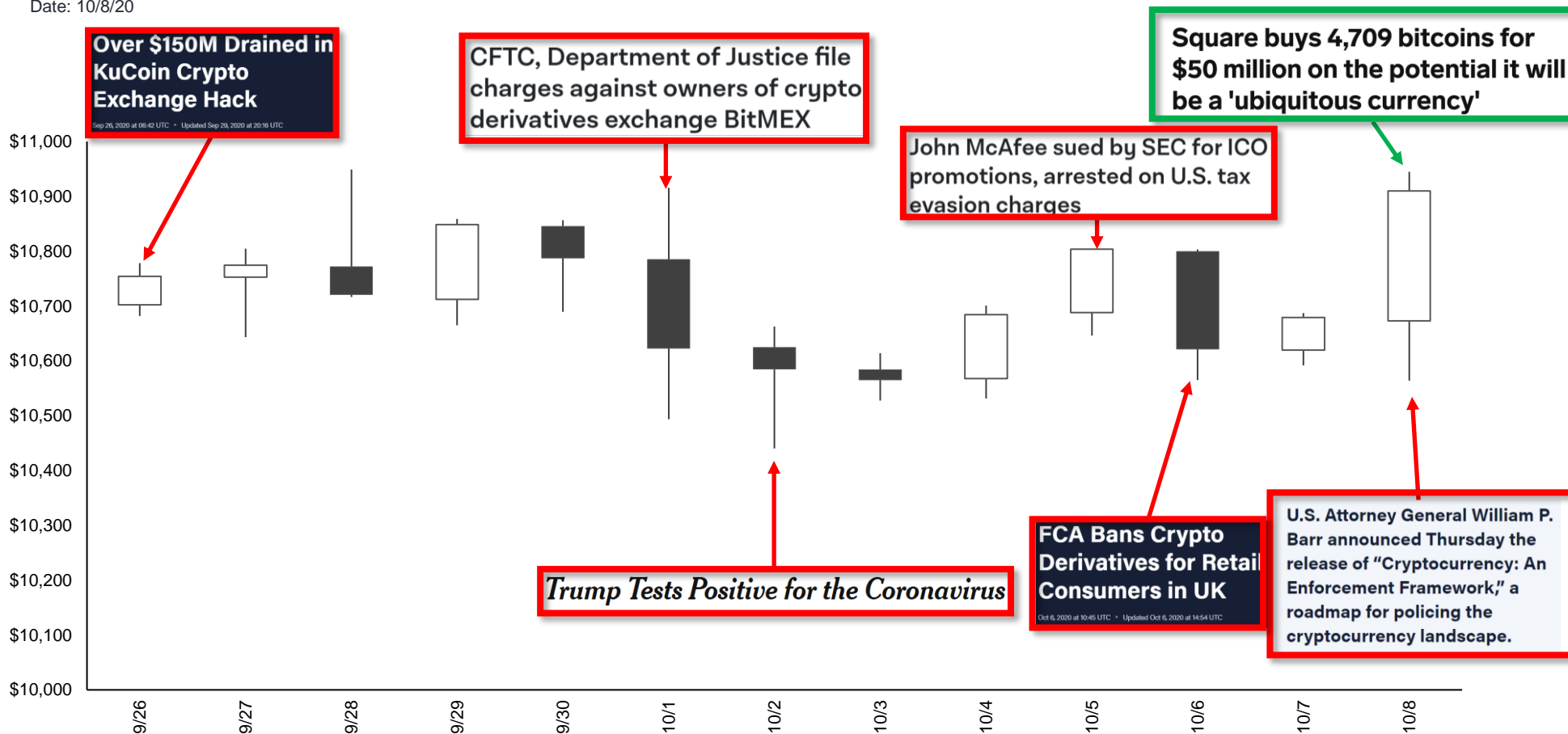
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## Bad news is no news while good news takes Bitcoin higher

The quarter end brought a ton of negative news to the space including the \$280 million KuCoin hack, the BitMEX indictment, Trump's COVID scare, enforcement against ICO promoter John McAfee, the UK's FCA ban of retail focused derivatives products, and finally the U.S. DOJ issuing a framework for crypto enforcement. Despite the onslaught of bad headlines, Bitcoin continued its consolidation above the key level of \$10,000, and the one piece of positive news, Square investing \$50M in crypto took market higher and left BTC sitting around \$10,900.

Figure: Bitcoin Price Performance

Date: 10/8/20



Source: FSInsight, CoinMarketcap

# Market sentiment and severity means all regulators actions aren't created equal

In a bull market, negative headlines fail to significantly push the price down. Bitcoin's resiliency in recent weeks re-confirm the prevailing bull trend is intact. Despite all the negative headlines this month, bears we unable to push Bitcoin's price below \$10,400 and the news of Square's Bitcoin position pushed it back towards \$11,000. We could be seeing a similar setup to 2016 which led to the rapid rise of 2017. If so, 2021 will be a very interesting year for Bitcoin.

**Figure: Bitcoin Price Performance**

Date: 10/8/20



Source: FSInsight, CoinMarketcap

## Despite CFTC & DOJ charges against BitMEX exchange rocking industry headlines

The biggest negative headline came last Thursday as the U.S. Department of Justice and the Commodity Futures Trading Commission (CFTC) filed charges against the leading crypto derivatives exchange BitMEX and its owners, including co-founder & CEO Arthur Hayes.

- **Hayes — along with co-founders Ben Delo and Samuel Reed — are accused of operating an unregistered trading platform as well as violating CFTC rules, including anti-money laundering and know-your-customer regulations.**
- **In a separate action, the Department of Justice filed criminal charges against Hayes, Delo, Reed and BitMEX head of business development Greg Dwyer with violating the Bank Secrecy Act. According to the DOJ press release, Reed was arrested in Massachusetts on Thursday morning "and will be presented in federal court there."**

Figure: BitMEX media coverage

### Bloomberg

Cryptocurrencies

## BitMEX Founders Charged With Failing to Prevent Laundering

By Chris Dolmetsch, Olga Kharif, and Dave Liedtka

October 1, 2020, 11:55 AM EDT Updated on October 1, 2020, 3:17 PM EDT

- ▶ Crypto-derivatives pioneer invented perpetual Bitcoin futures
- ▶ Bitcoin falls abruptly on news, after 50% rise since December

### The New York Times

## Owners of BitMEX, a Leading Bitcoin Exchange, Face Criminal Charges

BitMEX made itself a haven for hackers and illegal transactions, American prosecutors said.



- Arthur Hayes  
Co-Founder & CEO  
BitMEX

Source: FSInsight, Bloomberg, NYTimes

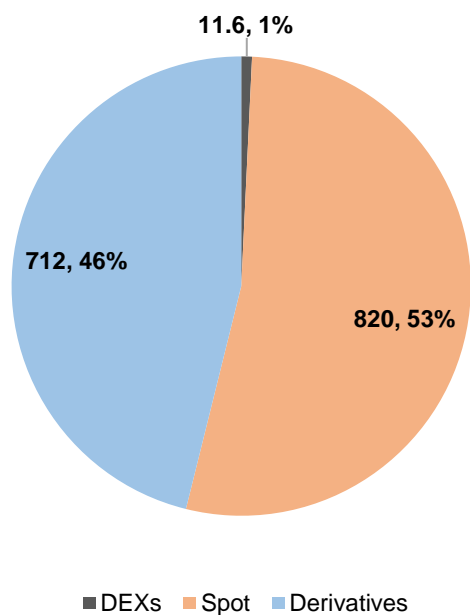
## Derivatives are half of crypto trading volume and BitMEX is a leading venue

The current crypto market structure is dominated by spot and derivatives exchanges. BitMEX makes up ~10% of the total derivatives volume, and although it is a significant player, it is far from the only game in town.

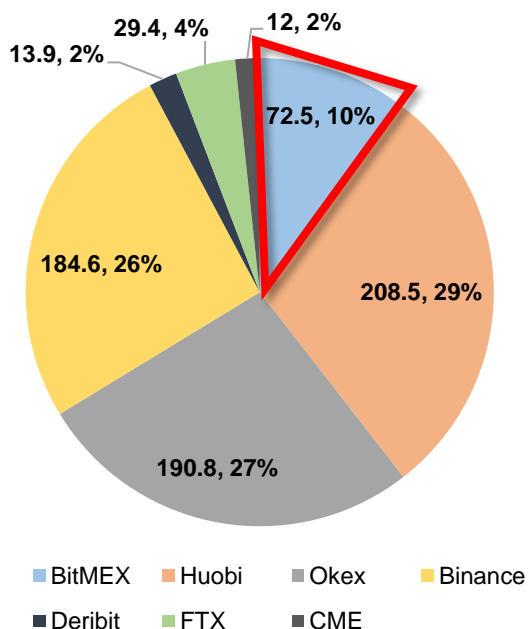
- Besides BitMEX, other regulated and unregulated derivatives trading venues have emerged and gained market share. This could explain why we have not seen significant market impact as a result of the regulatory action against BitMEX.
- DEXs are a small yet rapidly growing segment of the exchange ecosystem, currently making up approximately 1% of total trading volume, yet they offer pockets of risk highlighted by the BitMEX enforcement actions given they lack KYC/AML.

Figure: Crypto exchange volume by type, derivatives volume by exchange, futures open interest  
 Volume data as of August 2020 and open interest data as of 10/7/20

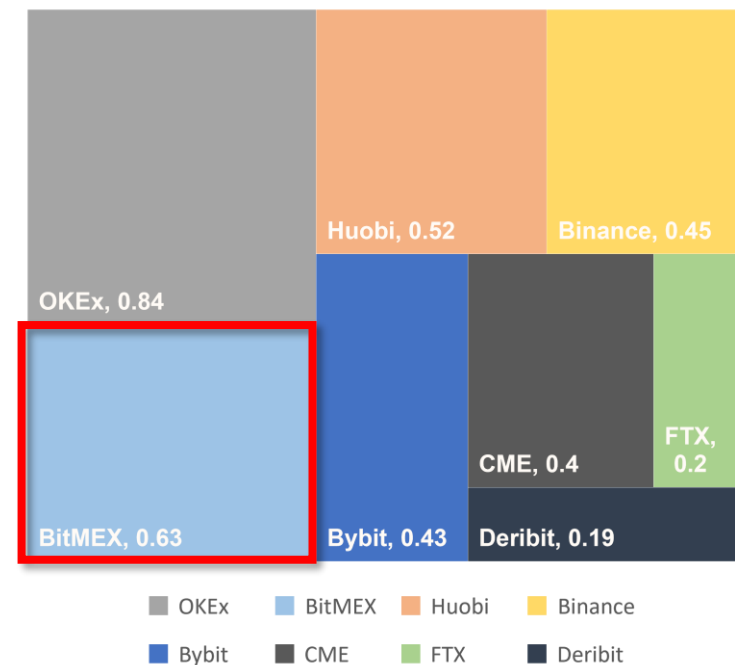
### Crypto Exchange Volume (\$ billions, %)



### Derivatives Volume by Exchange (\$ billions, %)



### Futures Open Interest (\$ billions)



Source: FSInsight, CryptoCompare, Skew

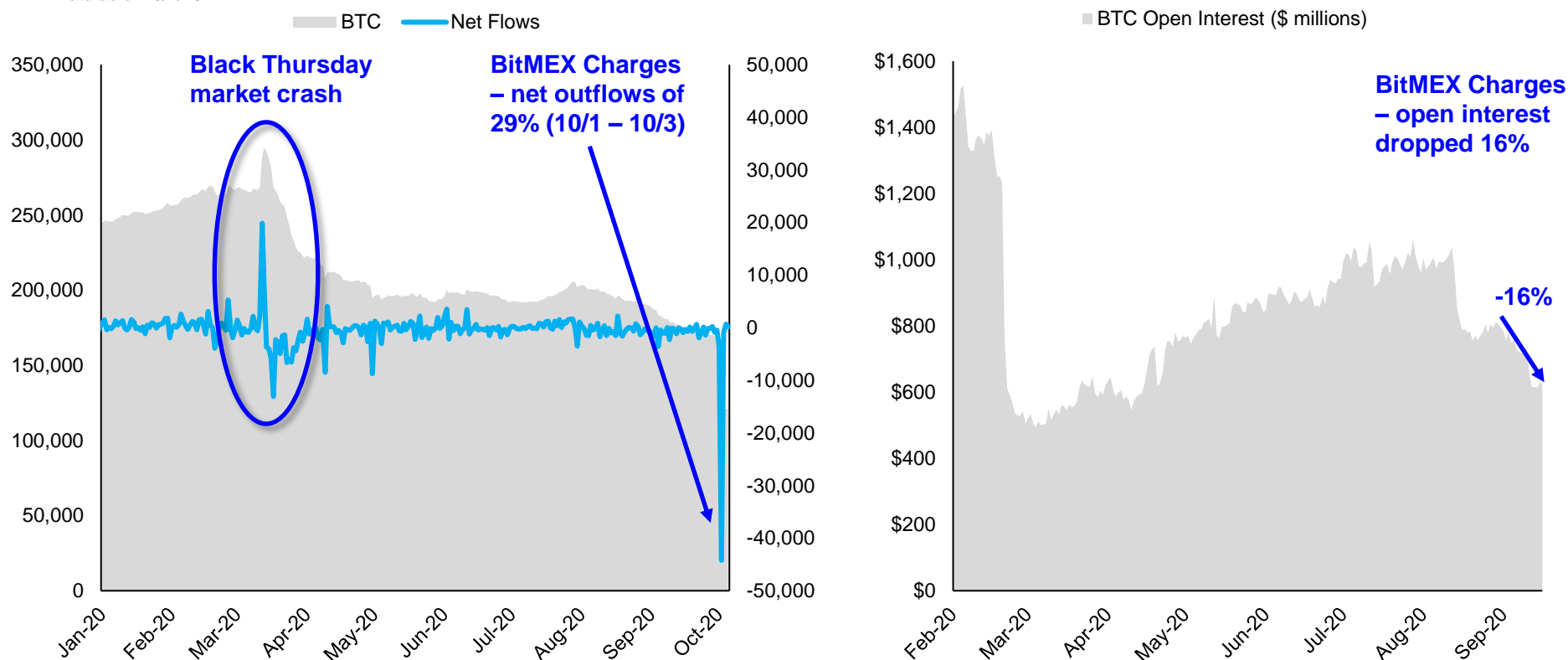
## Enforcement actions accelerated BitMEX decline but crypto remains bullish

As expected, the regulatory charges caused investors to close out positions and remove BTC from the exchange. In the days following the announcement, BTC outflows from BitMEX reached 29% or 48,500 BTC, and the perpetual swaps open interest dropped 16%.

- **Market infrastructure is much more mature than it was just a couple years ago, and many BitMEX competitors emerged including FTX, Bakkt, CME, Kraken, and ErisX. We expect BitMEX's BTC outflows and trading activity to make its way to other U.S. regulated trading platforms.**
- **Although they are slow moving, the regulators have shown they are dedicated to cleaning up the space. This is beneficial to the long-term growth of the space and could pave the way for more institutional adoption and possibly even a Bitcoin ETF.**

Figure: BitMEX net flows (BTC) and open interest (USD)

Data as of 10/7/20



Source: FSInsight, Glassnode



Interviews with key opinion leaders offer insights into what it means for markets

## Legal Insights

**CARLTON  
FIELDS**

- Andrew Hinkes  
Attorney  
Carlton Fields



## Index Insights

Bitwise

- Matt Hougan  
MD, Global Head of Research  
Bitwise Asset Management



## Capital Market Insights

**Genesis**

- Joshua Lim  
Head of Derivatives  
Genesis Global Trading



## Active Manager Insights

  
**arca**

- Hassan Bassiri  
VP, Portfolio Management  
Arca Funds



Source: FSInsight

## Key Opinion Leader Takes – Legal Insights: Carlton Fields

### Company Overview

**CARLTON  
FIELDS**

<b>Company:</b>	Carlton Fields
<b>Website:</b>	<a href="https://www.carltonfields.com/">https://www.carltonfields.com/</a>
<b>CEO:</b>	Gary L. Sasso
<b>Headquarters:</b>	Tampa
<b>Founded:</b>	1901
<b>Business Description:</b>	Leading provider of legal & consultative services to a broad spectrum of business clients

### Company Summary

- Carlton Fields has **more than 325 attorneys and consultants** serving clients from offices in California, Connecticut, Florida, Georgia, New Jersey, New York & Washington, D.C.
- The Blockchain and Digital Currency Practice covers **civil litigation, including securities litigation, regulatory defense, white collar defense, securities transactions, corporate, mergers & acquisitions, intellectual property, and money transmission-related matters.**
- Industry clients include **digital asset issuers, institutional and individual investors, entrepreneurs, exchanges, crypto mining firms, & others.**

Source: FSInsight, Carlton Fields

### Carlton Fields Commentary

#### **FSInsight: Why is this enforcement important for the industry?**

*Hinkes: “The industry seems to have focused on securities and commodities compliance, but FinCEN remains perhaps the most important regulator given their explicit connection to criminal enforcement and the severe penalties for failure to comply with BSA obligations. BitMEX was alleged to have operated an unregistered commodities exchange and to have failed to comply with even basic AML/KYC or BSA compliance. Given the criminal indictments, it seems as though the window to quietly settle this matter has long passed.”*

#### **FSInsight: How do you think things could play out for BitMEX?**

*Hinkes: “We don’t know if BitMEX will bring its practices into compliance or will shut down access to the platform to US persons. It is important to remember that, at this stage, everything in the civil enforcement action and criminal indictments are only allegations, and BitMEX has publicly denied those allegations. It appears that BitMEX will vigorously oppose the charges. As for the criminal indictment, at least one defendant has already been arrested; others may be in custody, although it has not yet been reported.”*

- Andrew Hinkes  
Attorney  
Carlton Fields





## Key Opinion Leader Takes – Legal Insights: Carlton Fields

**CARLTON  
FIELDS**



- Andrew Hinkes  
Attorney  
Carlton Fields

### Carlton Fields Commentary

**FSInsight: Are other exchanges or areas like DeFi at similar risk?**

*Hinkes: “To industry players who were paying attention, this was not a surprise; various media reported the CFTC’s investigation into BitMEX as early as last summer. Others providing similar leveraged trading contracts or exchange without proper AML/KYC or BSA compliance undoubtedly will need to clean up their acts. I won’t speculate which exchange or intermediary might be next, except to say that law enforcement is probably keeping an eye on DeFi protocols.”*

**FSInsight: If another action were to happen any clues on timing?**

*Hinkes: “I wish I had insight into when regulators brought their actions, but if patterns hold, the end of year and beginning of year would be important dates to watch.”*

**FSInsight: If the US government does have BitMEX leadership in custody and are able to shut down the platform, is there any risk for investors with assets on the platform that they could be frozen or seized?**

*Hinkes: “Although there is always risk of loss when using a centralized intermediary, if the government took control of BitMEX, there is a chance they could prioritize identifying and preserving user assets. Depending on the charges and allegations, some assets may be subject to seizure, but probably not the assets of run –of-the-mill users.”*

Source: FSInsight, Carlton Fields

## Key Opinion Leader Takes – Capital Market Insights: Genesis

### Company Overview

# Genesis

<b>Company:</b>	Genesis Global Trading
<b>Website:</b>	<a href="https://genesistrading.com/">https://genesistrading.com/</a>
<b>CEO:</b>	Michael Moro
<b>Headquarters:</b>	NYC
<b>Founded:</b>	2013
<b>Business Description:</b>	Institutional crypto OTC trading, derivatives, borrowing, lending, custody and prime brokerage services

### Company Summary

- Genesis launched the **first U.S. OTC bitcoin trading desk in 2013** and since then has grown to facilitate **billions in monthly digital currency trades, loans, and transactions**
- Genesis **provides two-sided liquidity for buyers and sellers of digital assets and derivatives**, backed by proven technology and an expert team of trading professionals.
- Genesis' loan facility helps clients increase capital efficiency and access alternative liquidity for **hedging, speculation, institutional market-making and working capital needs**.

### Genesis Commentary

**FSInsight: What role do you see BitMEX playing in the market?**

*Lim: "BitMEX has been the dominant venue for two segments of the market: active traders hedging OTC flows and basis traders. A highly liquid top of the order book and favorable rates made it the preferred venue for high frequency traders, major OTC shops, and the basis trading community arbitraging various maturities of futures to spot."*

**FSInsight: How disrupting do you think this is for market liquidity?**

*Lim: "The role BitMEX plays in the market has changed since the March Black Thursday market crash. The most significant market players have already started migrating to other platforms. If this BitMEX action had happened pre-March, it would have been a much bigger deal because so much liquidity had been there, but the market had time to sort this out and thus we saw little market impact and disruption."*

**FSInsight: Who are the main beneficiaries of the regulatory action?**

*Lim: "It's a positive for CME and U.S. institutional participation. The big beneficiaries are other regulated derivative venues that offer products that simulate BitMEX's perpetual swaps. Whereas BitMEX only offered Bitcoin-denominated swaps, alternative exchange products offer USD-denominated swaps with stable-coin-denominated collateral, which the market now views as safer due to the March crash."*

- Joshua Lim  
Head of Derivatives  
Genesis Global Trading



Source: FSInsight, Genesis Global

## Key Opinion Leader Takes – Active Manager Insights: Arca Funds

### Company Overview



**arca**

<b>Company:</b>	Genesis Global Trading
<b>Website:</b>	<a href="https://www.ar.ca/">https://www.ar.ca/</a>
<b>CEO:</b>	Rayne Steinberg
<b>Headquarters:</b>	NYC / LA
<b>Founded:</b>	2018
<b>Business Description:</b>	Institutional grade financial services firm building products utilizing and investing in digital assets

### Company Summary

- Arca is an asset management firm **offering institutional-caliber products for sophisticated investors** to gain exposure to digital assets.
- Arca Funds' flagship hedge fund strategy is a **long-biased, special situations strategy focused on capturing alpha in small and mid-cap digital assets** where there is little competition.

### Arca Commentary

#### **FSInsight: What is the medium to long term impact on the market?**

*Bassiri: We think this is a net positive for the industry in the long run. BitMEX pioneered the perpetual swap and historically was the primary venue for BTC price discovery given the volume and liquidity of the platform. For the industry to take the next step forward, trading venues need to adhere to the guidelines and rules set forth by the regulators to protect their customers. Unfortunately, BitMEX never did that and is now paying the price.*

#### **FSInsight: How are you repositioning your portfolio in response?**

*Bassiri: We do not use leverage, so this news did not impact the positioning of our portfolio or our bullish outlook for BTC, so we remain long spot. The fact that the BitMEX and the Trump COVID news did not cause a massive sell off demonstrates maturity and a healthy market structure - i.e., reduced leverage based on net open interest and funding rates.*

#### **FSInsight: How will DeFi be affected by the regulatory action?**

*Bassiri: "We think regulatory scrutiny will be applied to DeFi and that this accelerates the end of "decentralization theater". DeFi projects that have a backdoor admin button - i.e., are centralized - will come under the purview of the regulators. This is good because it forces projects to innovate, ship and decentralize faster. It's also bad because decentralization takes time and rushing code can lead to smart contract risk.*

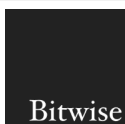
- Hassan Bassiri  
VP, Portfolio Management  
Arca Funds



Source: FSInsight, Arca

## Key Opinion Leader Takes – Index Insights: Bitwise Asset Management

### Company Overview



<b>Company:</b>	Bitwise Asset Management
<b>Website:</b>	<a href="https://www.bitwiseinvestments.com/">https://www.bitwiseinvestments.com/</a>
<b>CEO:</b>	Hunter Horsley
<b>Headquarters:</b>	San Francisco
<b>Founded:</b>	2017
<b>Business Description:</b>	Leading provider of liquid crypto index funds, benchmark indices, and educational market research

### Company Summary

- Bitwise funds offer a **liquid, low-fee, professionally-managed** way for accredited and institutional investors to **invest in crypto**.
- The **indices employ a robust asset inclusion methodology** that filters crypto constituents based on several factors that include an **advanced analysis of market structure and exchange liquidity**.
- Industry leading **research submitted to the SEC detailing crypto trading volume and market manipulation**. Extensive interactions with **top regulatory bodies concerning Bitcoin ETF proposals**.

### Bitwise Commentary

#### **FSInsight: How do regulators view crypto exchanges today?**

*Hougan: "I think they view it for what it is: A hodgepodge of truly institutional players like the CME, rapidly professionalizing crypto-native trading venues like Coinbase and LMAX, and a rag-tag long tail of less important venues operating in a variety of regulatory grey zones."*

*I think regulators have done a good job over the past five years creating a sandbox that has allowed a robust crypto trading ecosystem to emerge organically. Now, they are working to bring that ecosystem more firmly inside of regulatory safeguards."*

#### **FSInsight: What changes to market trading structure do you expect?**

*Hougan: I'd expect the trends we've seen over the past few years to accelerate. Those trends include the rapid professionalization of trading infrastructures, a shift of trading volume onto more regulated markets, and the continued growth of a robust derivatives market creating a robust two-way market in most major assets."*

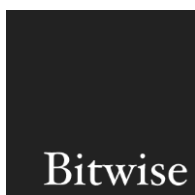
**Commentary continues next slide...**

- Matt Hougan  
MD, Global Head of Research  
Bitwise Asset Management



Source: FSInsight, Bitwise

## Key Opinion Leader Takes – Legal Insights: Carlton Fields



- Matt Hougan  
MD, Global Head of Research  
Bitwise Asset Management

### Bitwise Commentary

**FSInsight: What changes to market trading structure do you expect?**

*Hougan: “The level of improvement in the trading ecosystem in the past few years is just astonishing. Five years ago there were arbitrage opportunities in major cryptoassets like bitcoin that were big enough to drive a truck through. Today, it’s penny wide spreads. The arbitrage gaps have disappeared. I expect the market to continue to get better and better in the years to come.”*

**FSInsight: Does the BitMEX news impact the chances of a Bitcoin ETF?**

*Hougan: “Absolutely, and it’s great news.*

*Most people inside the crypto industry look at the SEC’s refusal to approve an ETF so far and think they are just being difficult. The reality is that they are asking good and tough questions about a rapidly emerging market. The SEC would be happy to see a bitcoin ETF approved if it can be satisfied that the market is developed enough to support it.*

*With that view, the BitMEX news is strictly positive. BitMEX was at best a cowboy trading venue pushing the limits of regulation, and the charges from the DOJ suggest it was worse than that.*

*The rubric for whether something helps or hurts the chances of a bitcoin ETF is simple: If it makes the trading ecosystem better, more professional and more regulated, it brings us closer to an ETF. The BitMEX charges achieved that in a major way.”*

Source: FSInsight, Carlton Fields

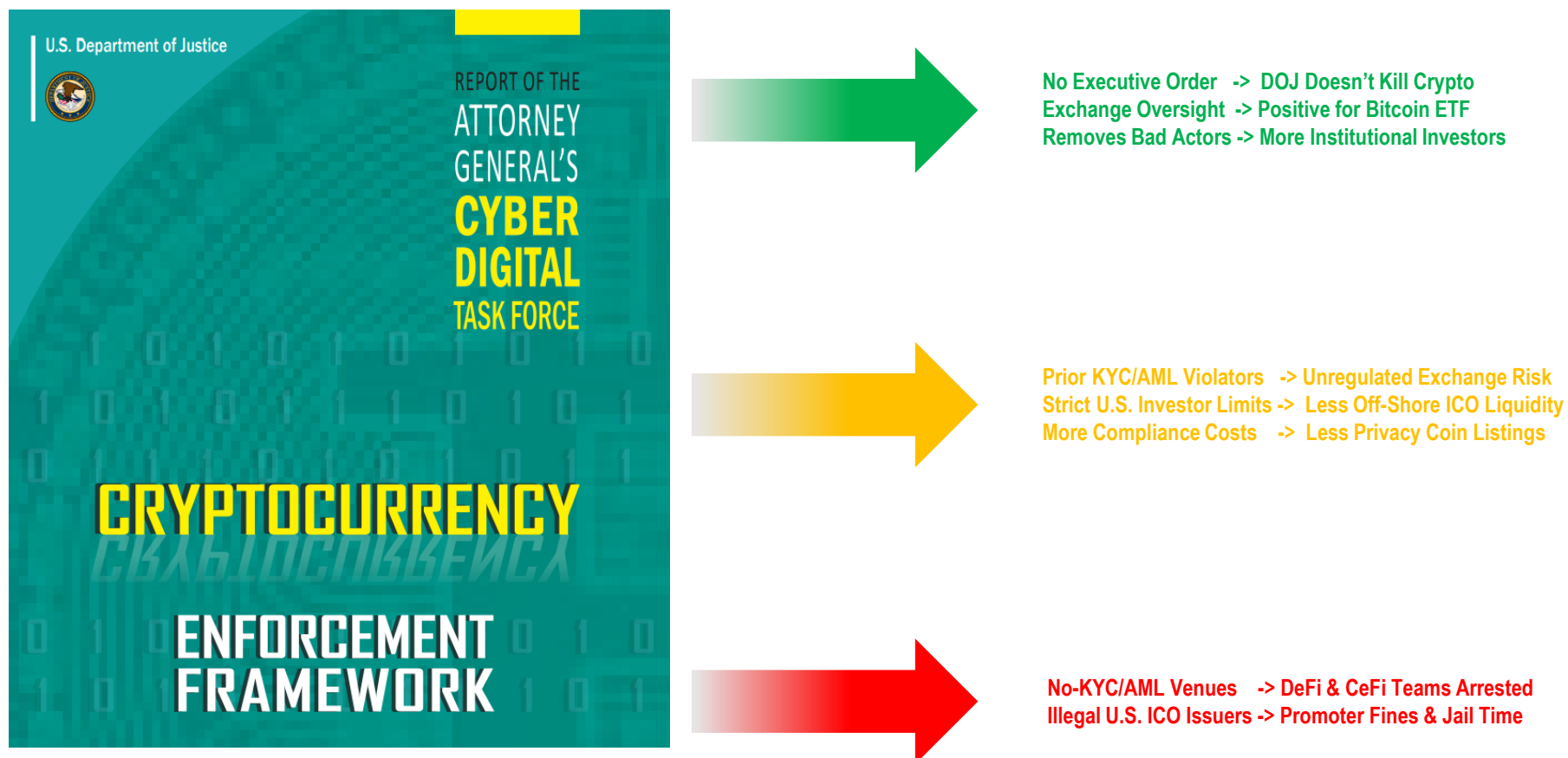
## What could recent regulatory actions mean for markets going forward?

The US Department of Justice issued an 83-page document “Enforcement Framework” that outlines the threats and challenges associated with crypto currencies as presented by the Attorney General’s Cyber Digital Task Force. The DOJ asserted it will exert its authority over foreign actors when "virtual asset transactions touch financial, data storage or other computer systems" with the U.S. for criminal activity.

- **Despite the draconian language in the report, the DOJ states “distributed ledger technology, upon which all cryptocurrencies build, raises breathtaking possibilities for human flourishing. These possibilities are rightly being explored around the globe.”**

Figure: DOJ Cryptocurrency Enforcement Framework

<https://www.justice.gov/ag/page/file/1326061/download>



Source: FSInsight, DOJ



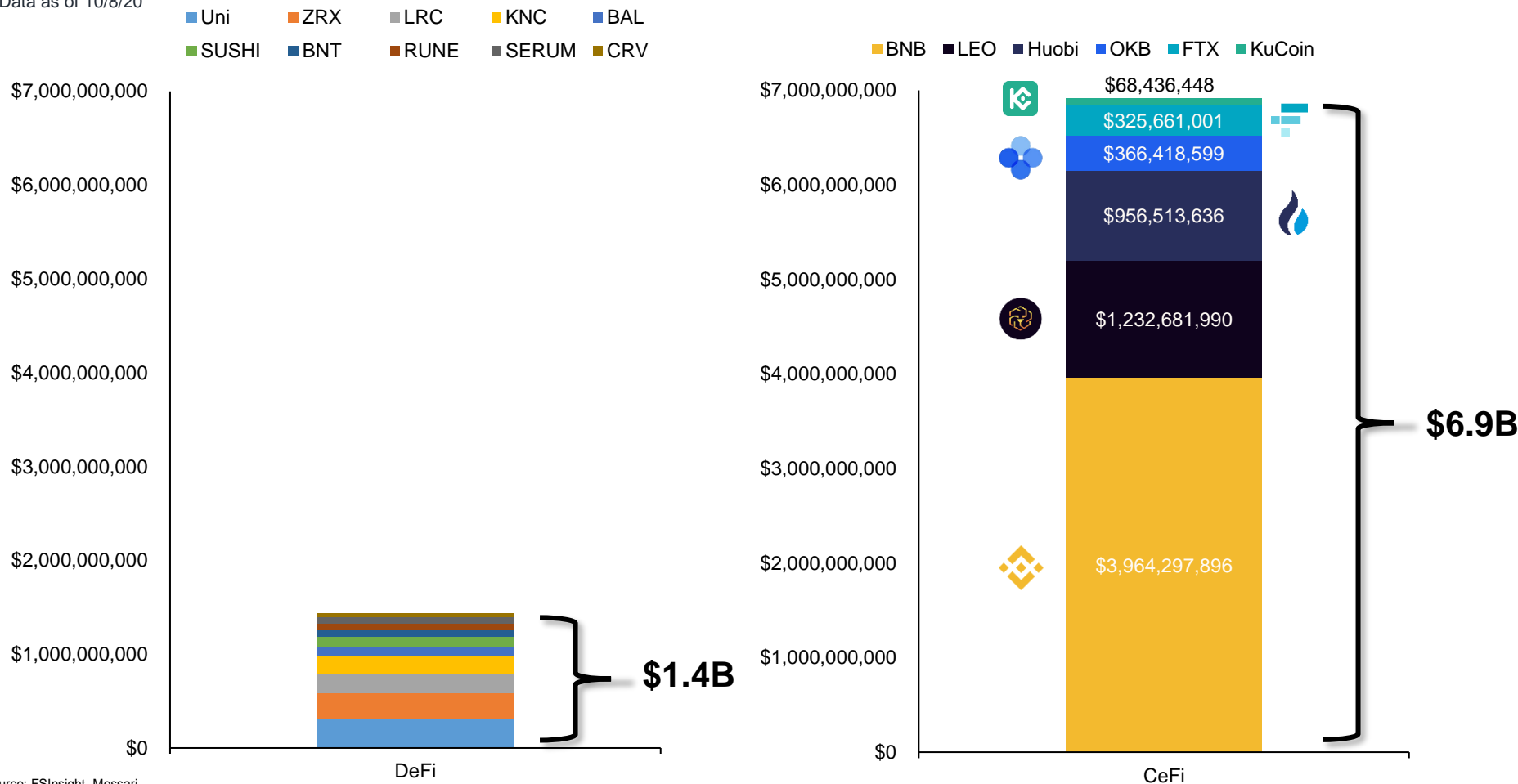
## Does BitMEX highlight regulatory risks for DeFi & CeFi off-shore exchange tokens?

Some offshore centralized exchanges and many decentralized exchanges could fall under the scrutiny of US regulators. These publicly traded tokens represent claims on the underlying exchange businesses and rely on them remaining operational. Centralized exchange tokens are more established and possess larger market capitalizations than their DeFi counterparts.

- Investors should be diligent about the risks inherent to unregulated exchanges that possess lax attitudes towards KYC/AML and regulatory compliance. Through these tokens, investors have the ability to price in their expectations for regulatory risk.

Figure: CeFi and DeFi aggregate market caps

Data as of 10/8/20



Source: FSInsight, Messari

## Could accusations against Binance put its off-shore exchange at risk like BitMEX?

Although Binance has recently launched Binance US to comply with US regulations, the vast majority of its volume is generated on its offshore non-U.S. regulated exchange.

- **Binance may capture a share of BitMEX’s lost volume in the near term. However, Binance has been accused of jurisdictional arbitrage, lax KYC/AML requirements, and listing potentially unregistered securities on its exchange – should accusations be true – could Binance find itself in a similar positions as BitMEX one day?**

Figure: Binance volume and quarterly performance

Data as of 10/8/20

### Binance sued for allegedly facilitating money laundering with 'lax KYC'

Binance's lax KYC requirements are creating more legal problems for the exchange.

### FATF hints at Binance as example of an exchange avoiding regulation

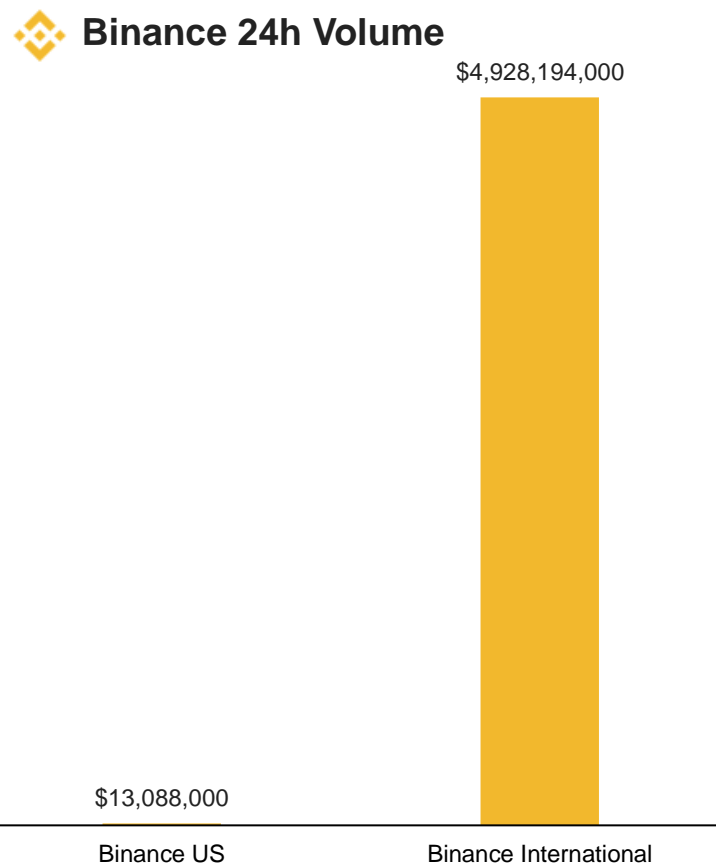
The FATF doesn't seem to like frequent jurisdiction hoppers, notably Binance.

### Recent Class Action Lawsuit Could Cost Binance Billions of Dollars

Could past mistakes may be catching up with Binance?

### Binance begins to restrict US users ahead of regulatory-compliant exchange launch

Jon Russell @jonrussell / 3:49 am EDT • June 14, 2019








Source: FSInsight, Binance, Coinmarketcap, Cointelegraph, Techcrunch

## Are regulatory risks for the largest exchange token BNB being properly priced?

The largest and most established US exchanges (including NYSE, CBOE, CME, and Nasdaq) have an average P/E multiple of 23.75, compared to Binance's multiple of 21.36. These exchanges offer slower growth, but they seemingly possess less regulatory risk and have larger market share.

- We're not making any legal/regulatory predictions related to what will happen to Binance – but it's investors should carefully consider if the relative risks are being properly priced.

Figure: Binance, ICE, CBOE, CME, & Nasdaq PE Comparison

Company	Ticker	Market Cap (10/8/2020)	LTM Earnings (Q2 2020)	Price/Earnings (PE) Ratio
 BINANCE	BNB	\$4,008,566,692	\$187,666,000	21.36x
 ICE NYSE	ICE	\$55,086,767,688	\$2,150,000,000	25.62x
 Cboe	CBOE	\$9,325,988,467	\$463,300,000	20.13x
 CME Group	CME	\$61,570,858,794	\$2,375,300,000	25.92x
 Nasdaq	NADQ	\$20,479,739,108	\$796,000,000	25.73x
Peer Average				23.75x

Source: FSInsight, Binance, Bloomberg

## Recent Reports & Events

**Access FSInsight's recent crypto insights if you missed them by clicking below or visiting FS Insight:**

- Tom Lee and David Grider: Tom and David gave a joint keynote presentation at the CoinGeek conference last Thursday October 1st. [Click here to see a recording of the event.](#)
- David Grider: [Digital Assets Weekly: September 29th](#)
- FS Digital Strategy Team: [Horizen: Web 3.0 Platform Targeting Big Tech Super App Disruption](#)

Source: FSInsight

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