UMA: A Decentralized Financial Contract Platform

December 3, 2018

Abstract

We present a decentralized protocol to enable the creation, maintenance, and settlement of financial contracts for any underlying asset. We propose novel systems for maintaining collateral and confirming off-chain information to enable market participants to trade with confidence and transparency. We show that trustless financial contracts remove all barriers to access for every financial market, creating a single global marketplace where any individual, smart contract, or decentralized autonomous organization can buy or sell any form of financial risk.

Contents

1 Introduction 3
   1.1 Brief History of Financial Contracts .................. 3
   1.2 Synthetic Asset Overview .......................... 4

2 Motivation 5
   2.1 Barriers Removed by UMA Contracts ................ 6
      2.1.1 Unrestricted Access to All Financial Markets .... 6
      2.1.2 DAO and Smart Contract Access to Financial Markets .. 6
      2.1.3 Unrestricted Access to Short Selling ............. 7
      2.1.4 Unrestricted Access to Leverage ................ 8
      2.1.5 Unrestricted Access to Customized, Bespoke Risk .... 8

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.2</td>
<td>Other Benefits of UMA Contracts</td>
<td>9</td>
</tr>
<tr>
<td>2.2.1</td>
<td>Tokenization of Financial Risk</td>
<td>9</td>
</tr>
<tr>
<td>2.2.2</td>
<td>Engineered Price Stability</td>
<td>9</td>
</tr>
<tr>
<td>2.2.3</td>
<td>Simplification of Institutional Custody Requirements for Cryptocurrencies</td>
<td>10</td>
</tr>
<tr>
<td>3</td>
<td>UMA Protocol Specification</td>
<td>10</td>
</tr>
<tr>
<td>3.1</td>
<td>Contract Architecture</td>
<td>11</td>
</tr>
<tr>
<td>3.1.1</td>
<td>Counterparty Public Addresses</td>
<td>11</td>
</tr>
<tr>
<td>3.1.2</td>
<td>Margin Accounts</td>
<td>11</td>
</tr>
<tr>
<td>3.1.3</td>
<td>Economic Terms</td>
<td>12</td>
</tr>
<tr>
<td>3.1.4</td>
<td>Termination Terms</td>
<td>12</td>
</tr>
<tr>
<td>3.2</td>
<td>Remargining Frequency Incentivization</td>
<td>14</td>
</tr>
<tr>
<td>3.3</td>
<td>UMA Contract Lifecycle</td>
<td>15</td>
</tr>
<tr>
<td>3.3.1</td>
<td>Example of Lifecycle without Default</td>
<td>15</td>
</tr>
<tr>
<td>3.4</td>
<td>Example of Lifecycle with Default</td>
<td>19</td>
</tr>
<tr>
<td>4</td>
<td>Implementation Mechanisms</td>
<td>20</td>
</tr>
<tr>
<td>4.1</td>
<td>Trustless Tokenization</td>
<td>20</td>
</tr>
<tr>
<td>5</td>
<td>Potential Issues and Risks</td>
<td>22</td>
</tr>
<tr>
<td>5.1</td>
<td>Margin Balance Security</td>
<td>22</td>
</tr>
<tr>
<td>5.2</td>
<td>Price Feeds and Market Data Oracles</td>
<td>22</td>
</tr>
<tr>
<td>5.3</td>
<td>Jump Risk and Margin Stop Outs</td>
<td>23</td>
</tr>
<tr>
<td>6</td>
<td>Future Work</td>
<td>23</td>
</tr>
<tr>
<td>6.1</td>
<td>Trade Negotiation Protocol</td>
<td>23</td>
</tr>
<tr>
<td>6.2</td>
<td>Margin Netting</td>
<td>24</td>
</tr>
<tr>
<td>6.3</td>
<td>Future Proofing: Currency and Blockchain Agnostic Approach</td>
<td>25</td>
</tr>
<tr>
<td>7</td>
<td>Conclusion</td>
<td>25</td>
</tr>
</tbody>
</table>
1 Introduction

The concept of programmable money has always been a core focus of blockchain research: Vitalik Buterin spoke of “providing users with more powerful ways of managing and entering into contracts using their money” in the original Ethereum white paper [1]. The UMA Protocol seeks to extend these efforts with a specification for trustless, decentralized financial contracts. We show that trustless financial contracts remove all barriers to access for every financial market, enabling a single global marketplace where any individual can buy or sell any form of financial risk. We further show that the UMA Protocol gives smart contracts and decentralized autonomous organizations (DAOs) the same access to all forms of financial risk, opening up dramatic new applications for decentralized financial products.

1.1 Brief History of Financial Contracts

A financial derivative is an arrangement between two parties based on an underlying asset. Instead of exchanging the actual asset, agreements are made to exchange cash or other assets instead of the underlying asset itself. As the value of the underlying asset changes, so does the net present value (NPV) of the derivative agreement.

Financial derivatives enable market participants to hedge risks that are otherwise impossible to buy or sell, making them one of the most useful concepts of modern finance. Before derivatives, commodity producers had no means of hedging against price decreases of their future production; commodity consumers had no means of hedging against price increases of their future consumption.

The first modern derivatives emerged in 1930s to allow commodity producers and consumers to hedge against price volatility by agreeing to exchange a commodity at specific price in the future. These early derivatives used a centralized clearing house to set specifications of the quality and quantity of a given commodity and manage the margin requirements that ensured both parties would be paid out according to the terms of the contract. These centralized clearing houses created a standard protocol for buyers and sellers to exchange risk, laying the foundation for modern exchange traded derivatives.

As financial markets expanded in the twentieth century, so did the demand for derivatives to hedge against new types of financial risk. The limitations of a standardized contract required by exchange traded derivatives led to the creation of the over-the-counter (OTC) derivative market. OTC derivative contracts are bespoke legal agreements between two counterparties specifying what each counterparty will pay the other as the value of the underlying asset changes.

A typical OTC derivative trade involves one counterparty, the taker, requesting a quote for a specific set of terms from one or more market makers. The
market makers agree to take the other side of the taker’s trade as principal, meaning that the maker may not have a preexisting position in the risk the taker is looking to buy or sell. By acting as principal, the maker assumes the responsibility to hedge or warehouse the economic risk of the trade; this differs from exchange traded derivatives where natural buyers and sellers of the same risk meet.

OTC derivatives benefit from immense flexibility—they can be written for literally anything—and their usefulness led to the rapid growth of the OTC derivative market in the 1990s and 2000s. It is estimated that over $540 trillion \[2\] in OTC financial derivatives are currently outstanding, making the OTC derivatives market the largest financial market in the world by an order of magnitude.

This flexibility comes at a cost: counterparty risk. Without a central clearing house, each market participant must trust that the other party will honor their contracts—even during violent swings in the underlying asset. When a counterparty fails (as Lehman Brothers and Bear Stearns did during the financial crisis of 2008), trust may fail and significant systemic risk is introduced into the market.

1.2 Synthetic Asset Overview

One particularly useful class of OTC derivative allows investors to achieve synthetic asset exposure. Instead of needing to hold a particular asset, an investor can enter a financial contract where the payments of the financial contract from one counterparty to another are a function of a statistic of the underlying asset, such as the price of the asset. One example of this is a total return swap (TRS). Although the UMA Protocol itself is extremely flexible and can be extended to almost any form of financial derivative, we focus on total return swaps as a core example.

A total return swap is a bilateral financial contract where one counterparty pays the total return of a specified underlying asset, including any interest payments or dividends and any capital appreciation or depreciation, and the opposing counterparty pays a regular fixed cash flow \[3\]. The fixed cash flow can be thought of as the interest rate cost to borrow the capital needed to purchase the underlying asset. The underlying asset is commonly called the reference asset and can consist of any combination of bonds, loans, equities or other financial assets. The swap is settled and terminated at a specified date in the future.

This structure allows a counterparty to receive all the economic benefits of owning (or selling short) an asset without the need to buy and custody (or borrow and sell short) the actual asset. Instead, the counterparty need only back the promised payments with margin. This is a powerful tool to buy or sell risk on any type of asset.
2 Motivation

Open financial markets require fair access for all market participants. The UMA Protocol promotes fair and open markets by removing all barriers to access for every financial market, allowing any individual, entity or DAO to access any type of financial risk, without any centralization or single point of failure.

The ability to buy and own (or borrow and sell short) a specific asset has traditionally been the biggest hurdle to accessing a desired financial risk. Derivatives solve this by replacing the need to custody assets with a contract that references the price of those underlying assets. This introduces a second hurdle: the ability to trust that the counterparty of your derivative agreement will honor the terms of the contract.

Trust, otherwise known as *counterparty risk*, is the Achilles’ heel of financial derivatives today. Because of the risks involved, financial derivatives have only been made accessible to a small number of sophisticated institutional investors who rely on traditional due diligence and costly legal process to “trust” each other. It has never been economical or practical to offer the benefits of derivatives to anyone besides the largest institutional participants.

We show that UMA contracts use only margin, economic incentives, and the transparency of the blockchain to allow any counterparty to gain synthetic asset exposure. In doing so, UMA contracts fully eliminate all barriers to accessing financial markets, creating a single global marketplace. The benefits of this universally accessible, open marketplace are hard to understate.
2.1 Barriers Removed by UMA Contracts

2.1.1 Unrestricted Access to All Financial Markets

Traditionally, individuals and businesses can only buy and sell financial risks that are supported by their local government and infrastructure. Regulations and custody requirements can make it extremely difficult (or impossible) for an individual or entity to buy anything not explicitly supported by their local financial system. Sophisticated institutional investors have been able to sidestep these access challenges using tools like OTC derivatives that remove the need to physically own or custody assets; these tools, of course, have not been available to the rest of the market.

UMA contracts bring this benefit to all market participants. They enable anyone to buy or sell exposure on any financial asset—market participants are limited only by what market makers are willing to price. Individuals in countries with weak financial infrastructures are no longer restricted to the limited investment options accessible in that jurisdiction. No walls exist—any person or entity with capital can access any risk, creating a single unified and truly global financial market.

Example 1: Investing in US stocks from the developing world

Many people around the world cannot access even the most liquid stock markets. Due to limitations or inefficiencies in local financial infrastructures, it is extremely difficult for most individuals in the developing world to invest in foreign assets like the US stock market. With an UMA contract, the foreign investor can enter into a total return swap that pays the same economics as directly investing in the US stock market, bypassing the limitations of that investor’s local financial system.

2.1.2 DAO and Smart Contract Access to Financial Markets

It seems inevitable that smart contracts and programmable money will create many new financial innovations; these contracts will need to invest, hedge, and trade in financial markets.

For a smart contract to access a financial market, it needs to be able to access that market on-chain. This presents a problem: how do you credibly reference a traditional, real-world asset on the blockchain? Some approaches like TrustToken use on-chain tokens to represent assets held in an off-chain legal structure; this approach is subject to a single point of failure and potential off-chain legal challenges.

UMA contracts represent another, potentially much more flexible solution: the smart contract simply becomes one of the counterparties of the derivative
agreement. Since the derivative references the underlying asset without needing to own or custody the asset, this conveniently sidesteps the problem of credibly representing the asset on-chain.

This allows any smart contract to access any type of financial risk, with potentially dramatic implications: ideas like decentralized private pension plans, decentralized insurance and annuity products, and DAO governed hedge funds or endowments all become possible.

Example 2: Decentralized life insurance

The first “mutual” companies were built to help groups of laborers and artisans pool their collective mortality risk, providing economic aid for families of the deceased. A collective insurance product can be built using the UMA Protocol, enabling any group of individuals to pay into a pool that pays a fixed payment based on their tenure upon their death (either measured by off-chain oracle or the participant’s failure to sign periodic challenges with their private credentials). This pool itself can invest into a diversified pool of assets (of both crypto and other traditional assets) using UMA contracts to access this risk.

2.1.3 Unrestricted Access to Short Selling

An obvious advantage of derivatives is the bilateral nature of the agreement: for every counterparty that goes long a certain type of risk, there is another counterparty that has the equal and opposite short risk. This provides a means to sell short or bet against assets that would otherwise be extremely difficult to borrow and short.

Sophisticated investors commonly use OTC derivatives to access short risk—some notable hedge funds used this technique to profit from the housing market collapse of 2008. But since traditional OTC derivatives are not accessible to most market participants, individuals and smaller entities have no way to access short risk in many markets.

UMA contracts remove this restriction. This creates better markets: basic economic theory posits that more market participants freely expressing their market expectations will create deeper, more efficient, markets. This is particularly true for traditionally one-way markets (like cryptocurrencies): frictionless access to short selling should reduce price volatility and promote price stability.

Example 3: Shorting a basket of altcoins

There has been explosive growth in both the number and value of crypto assets. But this market is almost entirely one-way: it is nearly impossible
to bet that prices will decrease. The few options that do allow you to short assets are centralized solutions that require trust in an exchange or traditional legal agreement. New decentralized solutions like dYdX are promising but still require a short seller to find an existing asset owner who will agree to lend their position. An UMA contract would provide an easy, simple way to bet against a basket of altcoins: a taker simply enters into a derivative contract with any market maker willing to take the other side. Market makers can hedge their long exposure by entering into other contracts with market participants who want to buy that risk.

2.1.4 Unrestricted Access to Leverage

By not requiring either counterparty to buy the underlying asset, financial derivatives like total return swaps are very capital efficient. The structure gives both counterparties leverage—they can invest in an asset while only locking up a small portion of that capital required to buy that asset (in the required margin).

Traditionally viewed as a type of loan, centralized exchanges and OTC market makers have only offered leverage to trusted and reputable counterparties. UMA contracts extend leverage to any counterparty, regardless of their credit rating or pre-existing reputation. This again removes barriers to access, potentially opening up new markets for investing and lending that were historically inaccessible to individuals and smaller entities.

Example 4: Getting a margin loan on a portfolio of cryptocurrencies

Given the dramatic changes in cryptocurrency prices, some crypto investors are sitting on substantial paper losses. An investor may want to get some cash (fiat) liquidity without reducing her long crypto exposure. This investor could sell half her crypto holdings and then enter a UMA contract to re-establish their long position with no additional outlay of capital.

2.1.5 Unrestricted Access to Customized, Bespoke Risk

Complex risks can easily be expressed in the economic calculations of a financial contract by referencing multiple underlying assets. This flexibility enables lower transaction costs by combining multiple trades into a single agreement—for example, a basket of assets that rebalances monthly can be represented by a single transaction. It also enables agreements to be tailored for the specific risk a given counterparty wants to buy, sell or hedge.

Customized, tailored-for-you financial contracts have never been available
to individuals as the costs for doing so have been prohibitive. UMA contracts change this and make it possible to offer anyone a financial contract that exactly fits their personal financial circumstances, in any market, globally.

Example 5: Investing in a “next-gen” robo-advisor

An investor wants to invest in a diversified portfolio similar to what’s offered by robo-advisors but with an exposure to crypto assets. This investor enters into an UMA contract to receive the total return of a portfolio invested 50% in the US stock market, 30% in the US bond market, 10% in bitcoin and 10% in ethereum. The agreement rebalances back to the original weightings every time an asset allocation shifts more than 2% from the target exposure.

2.2 Other Benefits of UMA Contracts

2.2.1 Tokenization of Financial Risk

Because UMA contracts are governed by smart contracts whose terms are defined by the contract counterparties, these smart contracts can use tokens to represent the risk exposure of each counterparty. If these tokens are fungible and conform to a standard, such as ERC-20, they are easily traded and transferred on exchanges. This expands the tokens’ visibility, allowing individuals to gain access to financial risk without directly interfacing with an UMA contract.

This is particularly important for investors with less capital, who need not commit to the notional of an UMA contract due to the tokens’ divisibility. Decentralized financial products, such as DAO hedge funds or other parties as mentioned in subsubsection 2.1.2, can also tokenize their exposure. This allows the entity’s smart contract to do the work of maintaining the exposure via an UMA contract, while the entity’s investors need only trade the tokens in their own wallets.

2.2.2 Engineered Price Stability

The price volatility of Bitcoin and other cryptocurrencies is commonly cited as the biggest barrier to cryptocurrency adoption. Stablecoins backed by fiat currency or commodities, like Tether or Digix Gold, rely on a centralized party or physical audits to guarantee their value. Decentralized solutions, like Dai and Basis, aim to solve this problem but have yet to obtain widespread adoption.

Generally, if an investor holding Currency A wants to invest in an asset denominated in Currency B, the investor’s exposure to the asset fluctuates with the FX rate between Currency A and B, because any returns in the asset must be converted into Currency A. Similarly, when obtaining synthetic asset exposure, it is most natural to calculate and deposit margin in the same currency as the
underlying asset. Because UMA contracts allow counterparties to define all of the economics of their exposure, counterparties are able to define financial contracts allowing for synthetic exposure regardless of the change in FX rate between the margin currency and the underlying asset’s currency.

2.2.3 Simplification of Institutional Custody Requirements for Cryptocurrencies

Investing in cryptocurrencies and other cryptoassets can be difficult for institutional investors. This is largely due to custody and accounting reasons: each new asset requires new systems and processes to be built, tested, and approved, creating significant barriers to entry for every new token or cryptographic system. Institutions can simplify this process by investing via financial contracts and standardizing their risk, custody, and accounting systems around a single standard—the UMA Protocol.

Example 6: Accounting and compliance friendly investing in “untraceable” cryptocurrencies like Zcash or Monero

Zero-knowledge cryptographic systems that aspire to make payments untraceable present a serious challenge for an institutional investor. Since the flow of funds is untraceable, it is impossible to audit an investment, preventing many institutional players from investing in things like Monero or Zcash. An UMA contract solves this problem by letting a hedge fund profit from changes in the value of the underlying reference asset without having to invest and custody that untraceable asset directly; risk and accounting systems can reference the accounting and compliance friendly UMA contract.

3 UMA Protocol Specification

UMA defines a decentralized protocol to enable the creation, purchase, and settlement of financial contracts for any underlying asset, and introduces novel systems for maintaining margin collateral to enable market participants to trade without counterparty or settlement risk. UMA does this by defining a generalized framework upon which financial contracts can be defined with mutually agreed economic terms, termination terms, and margin requirements. The UMA protocol uses smart contracts on the decentralized Ethereum VM to implement self-policing margin accounts; this allows the UMA protocol to be fully trustless and decentralized.
3.1 Contract Architecture

The UMA contract contains 5 core components:

- Public addresses of both counterparties (the maker and taker)
- Margin subaccounts: a margin account for each counterparty, accessible only to that counterparty and the contract
- Logic to calculate the economic terms of the agreement (known as the net present value or NPV)
- Choice of oracle for information regarding underlying asset
- Contract functions to add/withdraw margin balances, remargin, terminate, or settle the contract

![Figure 2: UMA smart contract structure](image)

3.1.1 Counterparty Public Addresses

Since the UMA protocol is fundamentally an agreement between two counterparties, the public addresses of both counterparties are immutably recorded in the smart contract at the creation of the agreement.

3.1.2 Margin Accounts

Each UMA contract has two margin subaccounts: margin\textsubscript{taker}, and margin\textsubscript{maker}.

The maker and taker margin accounts exist as subaccounts inside the contract and can be only be accessed by the maker and taker respectively, as well as by the contract. The maker and taker are free to add or withdraw funds from
their margin accounts at any time; they are only required to keep an appropriate balance in those accounts to meet the agreed upon margin requirements to avoid any potential early termination or default penalties.

Every time the contract is run and the economics terms (NPV) are recalculated, the contract moves the appropriate balance between the margin subaccounts so that the current NPV of the contract (which will be owed to either the maker or taker) is moved into the maker or taker’s margin subaccount.

3.1.3 Economic Terms

The economic terms of the agreement are immutably recorded in the code of the smart contract. This code references one or more price feed oracles that return the current price of the underlying reference asset; the challenge of securing the oracle price feed is discussed in more detail later in a separate white paper.

As an example, assume the taker wants to receive the total return of $10mm worth of gold for one year at the current price of 1 oz of gold = $1100. Since fiat assets cannot be transferred on the blockchain, the taker would like for all the calculated terms to be in USD, but paid in ETH. Assume a maker agrees to this in exchange for being paid 5% on $10mm for the length of contract. (This would approximate the maker’s cost of borrowing the funds needed to hedge their sale of gold with a small profit margin.) The economic terms of this agreement would be:

Taker Receives = \((price_{current}/price_{original} - 1) \times notional\)
\(= (gold_{price}/$1100 - 1) \times $10mm\) (1)

Maker Receives = \((date_{today} - date_{start})/365 \times rate \times notional\)
\(= (date_{today} - date_{start})/365 \times 5\% \times $10mm\) (2)

NPV = \([[(gold_{price}/$1100 - 1) - (date_{today} - date_{start})/365 \times 5\%] \times $10mm]\) (3)

If positive, the NPV is owed to the taker; if negative, it goes to the maker. Because the NPV is calculated in USD, the maker or taker will have to pay an amount of ETH equivalent to the NPV amount in USD (dividing the NPV value by the ETHUSD rate).

3.1.4 Termination Terms

The termination terms of the agreement are also recorded in the code of the smart contract. These terms are purposefully designed to be flexible and up to the mutual agreement of the counterparties. In most circumstances, the termination terms would include:
- The expiry date of the contract, after which the contract would terminate
- The settlement procedure for expired contracts
- Required margin balances for both the maker and taker
- The default procedure if the required margin balances are not met
- Any default penalties to be paid in the event of a default
- Any provisions for early termination

By defining this logic in deterministic, immutable code, the UMA Protocol simplifies many of the operational aspects found in traditional OTC swaps. The settlement procedure for expired contracts would empty the contract of all funds by sending the remaining margin balances back to the addresses of the maker and taker respectively.

### Sample UMA Contract Functions

<table>
<thead>
<tr>
<th>Function</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>calcNPV()</strong></td>
<td>Recalculate the economic terms of the function</td>
</tr>
</tbody>
</table>
| **terminate()** | Do the following:  
  (i) Check if either party defaulted on the margin terms; if true, execute the default procedure defined by the contract  
  (ii) Check if the contract has expired; if true, execute the settlement procedure  
  (iii) Do nothing (the contract is still valid) |
| **withdraw()** | Allow either the maker or taker to withdraw funds from their respective margin accounts into their public wallet addresses |
| **deposit()** | Transfer incoming funds into the margin account of either the maker or taker |
| **remargin()** | Do the following:  
  (i) Call calcNPV() to determine the current contract value  
  (ii) Move funds between the margin accounts such that the margin moved equals the current NPV  
  (iii) Call terminate() to determine if the contract should be terminated |

Table 1: Sample UMA Contract Functions

At the initial creation of the contract, both the maker and taker are required to contribute, at a minimum, the required margin balance to their respective
margin accounts. Counterparties have an incentive to contribute more than this minimum required balance since the contract will terminate under the default procedure if the NPV of the contract causes either party’s margin balance to drop below this minimum. As a further incentive to maintain sufficient margin, counterparties can agree to a default penalty to be paid on top of the NPV to any party that defaults. Although the contract cannot force a counterparty to pay a default penalty in excess of the balance in their margin account, if the required margin balance is set sufficiently above the default penalty amount counterparties can be reasonably sure they will get paid this penalty out of whatever funds remain in that margin account.

The margining terms of the contract are extremely flexible by design. Counterparties would change these terms to match the projected volatility of underlying reference asset—more volatile contracts would require more margin. It is also be possible to dynamically adjust the margin requirements by querying an oracle for the historic or implied volatility of the underlying asset.

Early termination is an optional feature of the contract. If both parties agree at the creation of the contract, the termination logic could include a mechanism for either counterparty to request an early termination which may optionally include an early termination fee.

### 3.2 Remargining Frequency Incentivization

The key constraint of any smart contract system is the cost of executing computations on a public blockchain. Our system is no different. It would be optimal if the `remargin()` function of the UMA contract could be continuously executed—the result would be a continuously, perfectly margined contract, with no need for any excess margin at any point. The realities of executing code on platforms like the Ethereum VM make this unrealistic.

Although the cost of on-chain computation is very expensive, modern cloud computing platforms make the off-chain calculation of the contract NPV and termination logic extremely cheap. For this reason, the UMA platform pushes the responsibility for monitoring and remargining the contracts back to the counterparties themselves. The UMA contract specification allows anyone, at any time, to run the `remargin()` function of any contract on-chain (so long as the requisite gas or equivalent computation cost is paid). Counterparties are therefore incentivized to continuously monitor the economic and termination terms of their contracts off-chain, and then pay the gas to `remargin()` on-chain only when it is economically beneficial for them to do so. Since the economic and termination logic of the contract is embedded into the public blockchain, there is no risk that off-chain observers run the wrong code or calculate an incorrect NPV.

One potential downside of this structure is that more sophisticated counterparties will develop better technology and systems to monitor and remargin
their contracts, creating an advantage over less sophisticated counterparties who may “forget” to remargin. Since anyone can call the remargin() function, this can be solved by third party keepers that agree to monitor a less sophisticated counterparty’s contracts for a small fee. Redundancy can further be introduced into this system by using multiple margin custodians.

3.3 UMA Contract Lifecycle

3.3.1 Example of Lifecycle without Default

Assume Alice, a taker, wants to receive on the total return of $10mm of gold for 1 year vs paying a fixed interest rate. Based on the current volatility of gold, Alice decides to set the minimum margin requirements at 5%, and sets a default penalty of 3%. Note that although the notional exposure, margin requirements, and default penalty are expressed in USD, all margin is paid and stored in ETH equivalent to those USD amounts. Assume initial level of 1 oz of gold = 1100 and initial price of 1 ETH = $100.

Alice initializes an open contract and deposits 10k ETH (currently worth $1mm).

<table>
<thead>
<tr>
<th>Alice’s Open UMA Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alice’s Address: 0x0000... 1111</td>
</tr>
<tr>
<td>Maker’s Address: null</td>
</tr>
<tr>
<td>Alice’s Margin: 10,000 ETH ($1mm)</td>
</tr>
<tr>
<td>Maker’s Margin: 0</td>
</tr>
<tr>
<td>Required Margin: $500k</td>
</tr>
<tr>
<td>Economics: Pay (or receive) total return of $10mm USD of gold purchased at $1100 USD/oz vs receiving (or paying) X% interest on $10mm USD</td>
</tr>
<tr>
<td>Termination: One year or in event of default</td>
</tr>
<tr>
<td>Default Penalty: $300k</td>
</tr>
</tbody>
</table>

Table 2: Alice’s Open UMA Contract

Alice sends this open contract to two known market makers, Bob and Charlie. Both Bob and Charlie decide to “make a market” on this contract, and both authorize the smart contract to withdraw 15,000 ETH (worth $1.5mm) from their accounts and deposit into the contract’s maker margin account if they win the trade (this more than satisfies the required margin of $500k).

Bob responds saying he will (i) pay the total return to Alice vs receiving
5%, or (ii) he will receive the total return from Alice vs paying 4.75%. Charlie quotes a market of (i) paying the total return vs receiving 5.2% or (ii) receiving the total return vs paying 4.9%. Both Bob and Charlie tell the smart contract that they will hold their markets for 5 seconds (the wire time).

Since Alice wants to receive the total return of gold, she accepts Bob’s offer to pay her the total return vs receiving 5%. (Alice would rather pay a fixed rate of 5% to Bob than 5.2% to Charlie). The smart contract informs Bob he is “done” on the trade and transfers the 15,000 ETH Bob already authorized into his margin account within the smart contract. The contract also cancels the margin withdraw authorization Charlie gave. The trade is confirmed and the complete contract details are recorded on the blockchain.

<table>
<thead>
<tr>
<th>Final Contract Between Alice and Bob</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alice’s Address: 0x0000... 1111</td>
</tr>
<tr>
<td>Bob’s Address: 0x1111... 2222</td>
</tr>
<tr>
<td>Alice’s Margin: 10,000 ETH ($1mm)</td>
</tr>
<tr>
<td>Bob’s Margin: 15,000 ETH ($1.5mm)</td>
</tr>
<tr>
<td>Required Margin: $500k</td>
</tr>
<tr>
<td>Economics: Alice receives the total return of $10mm USD of gold purchased at $1100 USD/oz vs paying Bob 5% interest on $10mm USD</td>
</tr>
<tr>
<td>Termination: One year or in event of default</td>
</tr>
<tr>
<td>Default Penalty: $300k</td>
</tr>
</tbody>
</table>

Table 3: Finalized contract between Alice and Bob

Alice and Bob have now agreed to a contract where their promises to pay each other are backed by ETH margin deposits in the smart contract.

Figure 3: Contract initialization between Alice and Bob

The next day, gold rallies to 1 oz gold = 1,199 while the price of ETH
remains unchanged. Off-chain, both Alice and Bob monitor and recalculate the NPV of the contract and margin requirements. Since gold rallied 9% (from 1,100 to 1,199) and since one day of interest has passed (worth $1370), both Alice and Bob calculate an NPV of $900,000 - $1,370 = $898,630 in Alice’s favor. Bob knows that if the contract’s remargin() function is called on-chain, the smart contract will move 8986.30 ETH (worth $898,630) from his margin subaccount to Alice’s margin subaccount. As a result, his margin balance of $1.5mm will be depleted by $898,630 and he will be dangerously close to dropping below the minimum margin requirement (and risk paying the default penalty of $300k). He therefore deposits an additional 10,000 ETH (worth $1mm) into his margin account inside the smart contract.

![Smart contract diagram](image)

Figure 4: Bob adds margin in anticipation of remargin

Meanwhile, Alice decides that it is worth paying the gas to remargin the contract on-chain. She calls the remargin() function and pays the necessary gas. The remargin() function calls calcNPV() which queries the designated gold price oracle and determines that the current NPV of the contract is $898,630 in Alice’s favor. The contract then moves 8986.30 ETH (worth $898,630) from Bob’s margin account into Alice’s margin account. Alice’s margin account has now changed from 10,000 ETH (at the start of the contract) to 18,986.30 ETH, and Bob’s margin account has now changed from 25,000 ETH (after Bob deposited an additional 10,000 ETH) to 16,013.70 ETH (after 8986.30 ETH were moved into Alice’s subaccount when remargin() was called on-chain).

As a last step, the smart contract checks that each of Alice and Bob’s margin accounts have enough margin to meet the margin requirements. Alice and Bob are able to observe this entire process since the margin balances of the contract are publicly available. Alice sees that her margin account now contains 18,986.30 ETH (worth $1.899mm), leaving her over-collateralized by 13,986.30 ETH (or $1.398mm) based on the $500k required margin amount. Alice could withdraw this 13,986.30 ETH if she so chooses. Bob’s margin account now contains 16,013.70 ETH (worth $1.601mm), leaving him over-collateralized by 11,013.70 ETH (or $1.101mm) based on the $500k required margin amount. Since both Alice and Bob’s margin account balances are above the margin requirement, the
contract remains valid.

The next day, while the price of gold remains unchanged, ETHUSD has weakened from an initial price of 1 ETH = $100 to a price of 1 ETH = $80. Bob sees that if Alice were to call remargin(), he would still be owed $1370 of interest, but that the smart contract would query the oracle and see that the value of ETH in USD terms had decreased. As a result, the oracle would move 17.12 ETH (now worth $1370 = 17.12ETH × $80 ETHUSD) from Alice’s account to Bob’s account, rather than 13.70 ETH. Note that in this contract, even though the values of each of the payments, margin accounts, and margin requirements are denominated in USD, the currency that is transferred to reflect these changes is ETH. The amount of ETH that is transferred is calculated at the time of transfer based upon the price of ETH in USD at the time.

The process continues with Alice and Bob continuously monitoring the NPV of the contract as well as the margin balances. Since Alice is not a professional market maker, she may also decide to hire a third party margin custodian or keeper to monitor and remargin her contract according to certain parameters.

After one year, gold has rallied to 1 oz gold = $1320 and ETH has weakened to 1 ETH = $80. On the day of termination, Alice calls remargin() a final time. The final NPV is calculated as a total return of $2mm (the appreciation of $10mm worth of gold from $1100 to $1320) less a fixed interest cost of $500k (the 5% interest on $10mm), leaving a total of $1.5mm owed to Alice. This amount corresponds to 18,750 ETH at a rate of 1ETH = $80. Assuming Alice and Bob have maintained their margin requirements over the lifetime of the contract, the cumulative margin movements between their accounts over the year effected by the remargin() function result in a net increase of 18,750 ETH in Alice’s account and a net decrease of 18,750 ETH in Bob’s account. The terminate() function then returns any remaining margin in Alice and Bob’s margin accounts to their respective public wallet addresses.
3.4 Example of Lifecycle with Default

Assume that the finalized contract between Alice and Bob as in Table 3 is entered. The next day, gold rallies to 1 oz gold = $1221 while the price of ETH remains unchanged at 1 ETH = $100. Off-chain, both Alice and Bob see that if the contract’s `remargin()` function is called on-chain, the USD value to be moved from Bob’s margin account to Alice’s is $1,100,000 - $1,370 = $1,098,630, and so the smart contract will move 10,986.30 ETH from Bob’s margin account into Alice’s. This would leave a remaining margin balance in Bob’s margin account of 4,013.70 ETH (worth $401,370), which is below the margin requirement of $500,000.

Bob sees this, and notes that while he would be in default if the contract were to be remargined, if ETH were to rally from 1ETH = $100 to 1ETH = $125 and the price of gold were to remain unchanged, his 4,013.70 ETH would be worth $500k and he would not be in default if the contract were remargined. He chooses to wait, hoping that the value of ETH/USD will change before the contract is remargined.

Alice, however, wishes to remargin the contract so that she can withdraw some of the resulting excess margin in her account. After she calls the `remargin()` function, the smart contract moves the corresponding ETH from Bob’s margin account into Alice’s.

![Smart contract transfers margin after remargin()](image)

After moving the margin, the smart contract runs the `terminate()` function to confirm that the margin balances still meet margin requirements and handle default. Seeing that Bob’s margin balance is below the margin requirements, the smart contract pays the default penalty of 3,000 ETH (worth $300k) from Bob to Alice and returns the remaining margin balances to Alice and Bob’s respective public addresses, closing the contract.

In hindsight, Bob would have been better off depositing an additional ~1,000 ETH into his margin account to meet the margin requirement than paying the 3,000 ETH default penalty for not having met the margin requirement.
4 Implementation Mechanisms

The UMA Protocol as demonstrated in the bilateral swap example enables counterparties to trade with leverage, but may not be the desired way of interacting with counterparties for many individuals. UMA contracts can be used as a mechanism by which counterparties can become makers or takers of risk for many different kinds of individuals. To meet the needs of these diverse individuals, we expect counterparties to develop a variety of use cases, or implementation mechanisms for UMA contracts.

4.1 Trustless Tokenization

The introduction of a fungible token offers a way to distribute the exposure of a bilateral swap to multiple investors without multiple margin accounts. This can be accomplished by fully collateralizing the one side of an UMA contract and then “tokenizing” it using a common interface like the ERC-20 standard. This allows for the creation of ERC-20 tokens that represent synthetic ownership of the long (or short) side of the underlying contract.

For example, suppose Alice would like to create $10mm worth of ERC-20 tokens that represent a long position in gold with the following characteristics:

- **Reinvested Exposure** Instead of maintaining a fixed $10mm notional exposure, Alice would like to reinvest the gains of her exposure or losses back into gold.

- **Maximum Loss** Alice would like to cap her losses at a maximum of $10mm. As a result, she will pre-pay all of her potential losses, but will never owe Bob any more than she initially deposited.

- **Perpetual Maturity** Alice would like to maintain this exposure perpetually, until she and Bob agree to terminate the contract.
These features are generally desirable to smaller or less sophisticated investors, who need not be concerned with depositing additional margin, defaulting, or checking the calendar to see if the exposure is maturing. They also have the peace of mind of knowing at all times what their maximum loss is. This is achieved by removing the leverage from Alice’s position, as she has to deposit the full amount of her exposure ($10mm worth of ETH) and will never owe Bob any additional margin. As a result, Alice’s margin account balance will always be ≥ 0, so the margin account can be tokenized. In return for depositing $10mm worth of ETH, Alice receives tokens representing a claim on the value of her deposit. As shown in Figure 8, this trustless tokenization is an extension of the original bilateral swap example as described in subsubsection 3.3.1 and shown in Figure 3, where Alice’s margin account is fully collateralized and the value of the margin in the account is converted into tokens. This diagram assumes that 1 ETH = $100 and that Bob initially deposits a 15% margin.

Ownership in these tokens can be further fractionalized, and Alice can distribute ownership via the existing infrastructure to support trading and custody of ERC-20 tokens. Suppose, for example, that Alice knows many other individuals in her community who also want to gain long exposure to gold, but who cannot buy physical gold or traditional financial products that reflect the price of gold. Alice may know that Bob is an experienced swap trader who already has dedicated resources to watching the market and maintaining margin positions, and who is comfortable trading gold products in the fiat world as well. Alice may enter an agreement with Bob where Alice is responsible for sourcing interest from investors for this token, Bob is responsible for providing the long gold exposure, and they enter an UMA contract representing the long gold exposure. Bob may not want to hold the long gold exposure himself, and may offset this risk in the fiat world with gold futures or gold swaps in the traditional financial market (the cloud in Figure 8). For this service, Bob may charge an annualized fee of 5%, but pay Alice a portion of that fee, say 1%. If Alice and Bob work well together, they may even formalize this partnership and begin operating as one entity.
5 Potential Issues and Risks

5.1 Margin Balance Security

The transferability of funds contained within the margin subaccounts of the smart contract is severely encumbered by design. At creation of an UMA contract, the public addresses of the maker and taker are immutably recorded on the blockchain. The logic of the contract then permits funds in the margin subaccount of each counterparty to be transferred only to one of two places: the public address of that counterparty or the margin subaccount of the other counterparty. Margin account funds cannot be transferred to any other address.

This design means funds embedded in the contract will never be transferred to any address other than those of the counterparties as agreed at the start of the contract.

5.2 Price Feeds and Market Data Oracles

The UMA Protocol requires reliable, consistent, and accurate price feeds to calculate the net present value of any agreement. Since no blockchain or cryptographic system has the innate ability to know things like the price of the S&P 500 or EUR/USD exchange rate, UMA requires a trusted oracle to communicate price and market data. If the oracle is compromised, the contracts could be manipulated.

The oracle problem is relevant to many domains outside of just financial contracts, and much work has been done to solve it. In 2014, Vitalik Buterin first proposed a game-theoretic approach of using Schelling points to find a truthful value from a crowd [7]. More recently, Zhang et al. proved the security properties of their Town Crier system for authenticated data feeds for smart contracts [8]. Commercial companies like Oraclize and SmartContract currently provide authenticated feeds using the TLSNotary [9] or Town Crier specifications, optionally using Intel SGX trusted hardware systems. Systems for combining multiple authenticated data feeds have also been proposed [10]; for example, price feeds like BTC/USD can be pooled from multiple exchanges with feeds weighted by trading volume or with outliers thrown out.

While these technologies greatly reduce the risk of oracle manipulation, counterparties are limited to selecting from available oracles. The UMA Protocol will also provide an oracle economically incentivized to be resistant to manipulation, to be described in a separate white paper. Since both counterparties agree to the economic terms of the contract at its creation, which includes oracle selection, both counterparties have an incentive to adopt the most trusted oracle.

Critics of oracle-based systems often point to the computational cost of pinging oracles on the blockchain, arguing that the cost and latency of these on-chain
transactions falls far short of what is achievable with centralized exchanges. The UMA Protocol sidesteps this by putting the responsibility for monitoring and remargining contracts in the hands of the counterparties, where off-chain monitoring costs are minimal. Oracles only need to be called on-chain when either counterparty decides to run the contract’s \texttt{remargin()} function on-chain.

### 5.3 Jump Risk and Margin Stop Outs

Any financial contract that uses margin or leverage has some risk of a violent, unexpected price move quickly depleting the margin of a counterparty: we call this \textit{jump risk}. Traditionally, the solution to this was to rely on some trusted reputation framework (like the legal system) to ensure that margin calls were met; the UMA Protocol purposely avoids this.

The UMA Protocol allows counterparties to self-manage jump risk by specifying the required margin, default procedure, and default penalties at the creation of the contract. Counterparties are naturally incentivized to set higher margin requirements on contracts with more volatile assets, and to set higher default penalties for contracts where defaults are costly (\textit{i.e.} contracts with risk that is difficult to hedge or to recreate). These terms can be set dynamically too: contracts could specify the margin requirements by querying an oracle for the current volatility of the underlying asset, thereby allowing margin terms to adjust to changing market conditions.

### 6 Future Work

#### 6.1 Trade Negotiation Protocol

A trade negotiation protocol is a system for swap counterparties to successfully match. The objective is to create a deep and liquid marketplace that matches a counterparty looking to express a certain risk (the taker) with multiple counterparties willing to take the other side of that risk (makers). The taker can then select the maker with the best possible price; competitive forces between makers will naturally push bid/offer spreads to the minimum cost required to hedge the desired risk.

It will eventually be up to developers to write their own trade negotiation protocols, potentially leveraging existing technologies to build relayers or other communication methods. One potential proposed implementation could work as follows, although it is not intended to be the only one that is built nor the best or most efficient protocol. It is modeled after the OTC swap market, arguably the deepest and most liquid financial market in the world.

Trade negotiation could be implemented as follows:
1. The taker initializes a UMA smart contract with the terms of the agreement they are looking to enter (specifying the expiry date, notional, economic formula, termination terms, and other required terms). The taker does not specify which direction they want to go (i.e. long or short the underlying asset).

2. The taker transfers the minimum margin required into the empty contract.

3. The taker selects one or more market makers and sends them the incomplete contract.

4. Makers respond with two-way quotes on the contract (they do not know the direction of the trade). Makers also authorize the smart contract to withdraw that minimum margin required if the trade is confirmed. The quotes and margin authorizations expire after a short amount of time, known as the wire time.

5. The taker selects the quote that is most favorable for the direction they want to go and confirms the trade with that maker before the wire time expires. After confirming the trade the maker owns the risk and decides if, how, and when to hedge.

6. The smart contract withdraws the authorized margin from the winning maker and deauthorizes any margin authorizations from losing quotes. All details are immutably recorded on the blockchain.

### 6.2 Margin Netting

As the UMA ecosystem becomes more liquid, market makers will seek to reduce the total amount of margin required for their portfolio of contracts. Consider the instance where Alice has two offsetting trades, one that pays the total return of $1mm BTC to Bob, and another that receives the total return of $1mm BTC from Charlie. Without some form of margin netting, Alice would be required to post required margin to both these contracts—even though she has no risk between the two positions.

Forthcoming research will detail mechanisms for market makers and other frequent users of the UMA Protocol to net contracts of similar risk, vastly reducing the total amount of capital required by market makers with offsetting trades. The risk exposure, margin requirements, remargining rules, and governance of these netted trades are publicly visible on the blockchain, maintaining all the benefits of the decentralized and trustless protocol.
6.3 Future Proofing: Currency and Blockchain Agnostic Approach

Although the UMA Protocol is currently implemented using the Ethereum blockchain with Ether (ETH) as a common currency for all margin transfers and settlement payments, the specification is designed to be blockchain and currency agnostic. The protocol is easily portable to other blockchains, and it is our expectation that market participants will identify the blockchain most compatible with best practices, standards, and incentive mechanisms. This supports our vision of a single, unified global marketplace, supported by a common, unified, protocol.

7 Conclusion

The UMA Protocol is a decentralized specification to enable the trustless transfer of financial risk for any underlying asset to any individual around the world. The protocol uses novel systems and economic incentivies to transparently and efficiently maintain collateral and accurately settle transactions while giving users complete control over the terms of their economic exposure. Combined, these properties enable and empower individuals to transfer financial risk, regardless of geographic location.

References

[1] Ethereum: A Next-Generation Smart Contract and Decentralized Application Platform
   https://github.com/ethereum/wiki/wiki/White-Paper

[2] OTC derivatives statistics at end-June 2017
   https://www.bis.org/publ/otc_hy1711.htm


   https://www.trusttoken.com

   https://whitepaper.dydx.exchange

https://blog.ethereum.org/2014/03/28/schellingcoin-a-minimal-trust-universal-data-feed/


https://tlsnotary.org/TLSNotary.pdf

https://medium.com/@roman.brodetski/introducing-oracul-decentralized-oracle-data-feed-solution-for-ethereum-5cab1ca8bb64

https://www.sifma.org/about/

[12] International Swaps and Derivatives Association Website. 
https://www.isda.org/about-isda/


https://variabl.io/