

# The Yield Protocol: On-Chain Lending With Interest Rate Discovery

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## Abstract

This paper presents a sketch of a new building block for decentralized finance: yTokens. yTokens are like zero-coupon bonds: on-chain obligations that settle on a specific future date based on the price of some target asset, and are secured by collateral in another asset. By buying or selling yTokens, users can synthetically lend or borrow the target asset for a fixed term. yTokens are fungible and trade at a floating price, which means their “interest rates” are determined by the market. The prices of yTokens of varying maturities can be used to infer interest rates, and even to construct a yield curve. yTokens can be built using an on-chain price oracle, or, when the target asset is an on-chain asset, using “physical settlement.”

## 1 Introduction

The Yield Protocol is a standard for a token that settles based on the value of a target asset on a specified future date, and which is backed by some quantity of a collateral asset. We call these tokens “yTokens.”<sup>1</sup>

You can create yTokens by depositing collateral, then sell them to effectively borrow (and short) the target asset. Buying yTokens is economically similar to lending the target asset. The effective “interest rate” received by yToken holders is determined by the discount at which yTokens currently trade, as well as the time to maturity.

yTokens can also be used as a building block for more sophisticated products. While each maturity of yTokens has a fixed expiration date, you could build a perpetual product on top of it, by implementing a pool that invests in short-term yTokens and automatically rolls them over upon expiry.

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<sup>1</sup>This nomenclature is inspired by the “cTokens” used in the Compound Protocol [1].

Perhaps most interestingly, the market prices of yTokens can be used as an “interest rate oracle.” The price of each maturity of yToken implies a particular yield. These implied yields could be used to settle on-chain interest rate derivatives, to inform Maker’s choice of stability fee, or as an input to the interest rate formulas used by Compound or dYdX. By charting those yields for different maturities, we can even construct a yield curve, which could be a useful indicator of the expected path of interest rates or prices.

This paper will present two constructions of yTokens. The first (“cash settlement”) assumes the existence of a price oracle that, when asked, can tell the contract the value of the target asset in terms of the collateral asset. The second (“physical settlement”) does not require any price oracle, but assumes that the target asset is itself a token (rather than an off-chain asset like USD).

## 2 Prior work

The design of the Yield Protocol is heavily influenced by other projects on the Ethereum blockchain that offer synthetics, borrowing, lending, and/or leverage. Yield primarily differs in that its interest rates are implicit and set by market prices, rather than being set by governance or a formula. Additionally, whereas most lending protocols use floating interest rates, Yield enables term loans with fixed interest rates, while still maintaining some degree of fungibility. Section 4.3 shows how, thanks to these properties, the Yield Protocol can provide unique insight into the term structure of interest rates for on-chain lending.

Synthetic asset systems, like Maker [2], Synthetix [3], UMA [4], and the Rainbow Network [5], create tokens that are pegged to a target asset but backed by a different collateral asset. These synthetics are supposed to trade at parity with the target asset (which often necessitates some kind of interest rate, usually set by governance or agreement of the parties involved). By contrast, yToken prices are expected to float, and the interest rate is implied by the discount at which they trade. Also, these synthetics are often designed to be perpetual instruments, whereas yTokens have an expiration date.

Systems for on-chain lending or margin trading, such as Compound [1], Fulcrum [6], and dYdX [7], allow users to deposit assets to be lent out for interest, and/or as collateral for their own borrowing. These protocols offer floating “overnight” interest rates determined by a formula, and positions can be withdrawn at any time. By contrast, Yield’s interest rates are determined by the market price of yTokens. Holders earn a predictable interest rate if they hold their yTokens to term, but “withdrawing” early requires selling yTokens on the market, and thus might incur a loss.

An early iteration of Dharma [8] was a secured lending platform that allowed users to enter into collateralized loans with a fixed term and interest rate. Lenders and borrowers were individually matched. Positions in Dharma were tokenized, but were not fungible (even if they had the same expiration date), making price discovery and liquidity provision more difficult.

## 3 Mechanism

This section describes the yToken mechanism at a high level. For simplicity, this description assumes the existence of a synchronous free on-chain price oracle for the underlying asset. Section 5 discusses other constructions of yTokens that do not depend on this assumption. We expect that when the target asset is itself an ERC20 token (like DAI, USDC, or ETH), some version of the “physical settlement” construction described in section 5.2 will be the best choice.

yTokens differ from each other in four dimensions: target asset (or oracle), collateral asset, expiration time, and collateralization requirement. Anyone can define a particular yToken by specifying those four parameters. For example, there would be one yToken for a given USD oracle, backed by ETH, settling at 11:59 PM on December 31, 2019, with a 150% collateralization requirement. Applications will be somewhat incentivized to converge on focal points (*i.e.*, by conventionally only buying or selling yTokens that expire at the end of each quarter), to ensure that liquidity is not too fragmented.

Each yToken has its own ERC20 token contract. These contracts are initialized and tracked using a global registry contract.

### 3.1 Minting yTokens

Once a token contract exists for a particular yToken, anyone can deposit collateral to create a *repo*. A repo is similar to a collateralized debt position (CDP) in the Maker system. The owner of a repo can mint yTokens, which adds to the repo’s *debt*. They can also burn yTokens to reduce their debt. The debt of a particular repo must not exceed the value of its collateral plus some required *margin*, or it will be *liquidated*, as described in section 3.3.

A yToken resembles a secured zero-coupon<sup>2</sup> bond. Upon expiration, it can be redeemed from the yToken contract for its face value. yTokens from different repos in the same token contract are fungible.

### 3.2 Settlement

After expiration, yTokens can be redeemed for their face value, with the redeemer receiving the appropriate amount of the collateral asset. Mechanically, as soon as a particular yToken expires, anyone can call a function on the token contract that triggers *settlement*. That function calls the oracle to look up the current price of the target asset in terms of the collateral asset and stores it as the settlement price. After that point, anyone can redeem yTokens for an equivalent amount of collateral, at the settlement price.

Additionally, any repo owner can close out their repo for its net value (the value of the collateral minus the value of its outstanding debt).

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<sup>2</sup>You can construct an instrument that includes coupon payments by creating a collection of different yTokens, with different face values and maturities. This process is essentially the inverse of “coupon stripping” from traditional finance.

### 3.3 Liquidation

If the price of the collateral asset falls relative to the target asset before a yToken expires, some of the repos—and thus the yTokens they back—may become undercollateralized. To protect against this, anyone can liquidate a repo that is too close to being undercollateralized.

A repo can be liquidated if the value of its collateral (the current price of the target asset in terms of the collateral asset,  $P$ , times the quantity of collateral in that repo,  $C$ ) is less than the value of its debt  $D$  adjusted for the collateralization requirement  $R$ :  $P \cdot C < D \cdot R$ . The liquidator burns  $D$  of the same yTokens, and receives  $C$  collateral.

The extra margin in the contract serves as a penalty for the borrower and an incentive for the liquidator. When  $D < P \cdot C < D \cdot R$  for a particular repo, someone can collect a profit by liquidating that repo. This also incentivizes borrowers to top up their repos with additional collateral (or pay down debt) to avoid liquidation.

For example, suppose a repo for a yToken with a collateralization requirement of 150% has 1 ETH as collateral, and outstanding yToken debt with a face value of 100 USD. If the price of ETH drops to \$149, someone can liquidate the repo by burning 100 yUSD and receiving 1 ETH, for a total profit of at least \$49 (in fact a little more, assuming the yUSD was trading at a discount).

However, if the price drops so quickly that a repo goes from  $P \cdot C > D \cdot R$  to  $P \cdot C < D$  before anyone has a chance to liquidate it, it is possible for the system to become undercollateralized. In the above example, this would happen if the price of ETH fell from \$150 to \$99 before someone was able to profitably liquidate it. This “gap risk” is one reason to set high collateralization requirements, especially when the backed asset or target asset is particularly volatile.

## 4 Applications of yTokens

yTokens are a low-level primitive, and they are not designed to be particularly friendly to end users. However, they could be used to construct interesting products by composing them with other protocols or building human interfaces on top of them.

### 4.1 Borrowing, lending, and leverage

yTokens enable a fungible market for fixed-term secured lending on-chain. By minting, holding, and/or trading yTokens, users can synthetically borrow and lend the target asset. Users are guaranteed a particular interest rate if they hold the position to maturity.

### 4.1.1 Borrowing

Opening a repo, taking out yTokens, and selling them is economically similar to *borrowing* the target asset and selling it. If the price of the target asset rises, so does the value of your debt, so the value of your repo decreases. You might want to do this if you expect the target asset to fall in price (“shorting”), or if you expect the collateral asset to rise in price and want to increase your exposure to it (“leverage”).

Traders can get additional leverage by trading the yTokens for more of the collateral asset, depositing it into the repo, and taking out more yTokens. This gives them greater long exposure to the collateral asset (and greater short exposure to the target asset), but increases their risk of getting liquidated. An application could abstract away this process for the user.

The yToken contract could also be designed to make leveraged trading more efficient, by having a function that atomically mints yTokens, sells them on Uniswap [9] for the collateral asset, and only *then* checks that the repo is sufficiently collateralized (reverting the entire transaction if it is not).

### 4.1.2 Lending

Buying yTokens is economically similar to *lending* the target asset. Because yTokens are not redeemable until expiration, they are likely to trade at a discount until maturity, particularly if there is demand to borrow the target asset. This means the value of yTokens (denominated in the *target* asset) will tend to appreciate over time as they approach maturity. This is analogous to the interest earned by lenders in other protocols.

In order to make this more familiar for users, an application could present an interface that emphasizes the *market value* of their yTokens, rather than the face value, as well as showing them the expected annualized yield if they held those tokens to maturity. For example, if a user spent \$100 to buy 103 yUSD, the interface would display their current value of \$100, with that number gradually tending to rise until it hits \$103 upon expiration.

However, note that it is possible for yTokens to temporarily *decline* in value relative to the target asset. This poses something of a user interface challenge—a user earning “interest” on their DAI might be surprised to see their portfolio value tick down (even though it would necessarily correspond to the interest rate going up, and the lender could receive the full value simply by holding the yToken to maturity).

### 4.1.3 Example

Suppose that on October 1, 2019, Alice owns 1 ETH, currently worth \$100, and she wants to enter a 1.5x leveraged long position on ETH. Alice looks up the USD/ETH yToken contract that expires at the end of the quarter (on December 31, 2019) with a collateralization requirement of 150%.

Alice creates a repo in that yToken contract, deposits 1 ETH as collateral, and takes out 50 yUSD as debt. Alice then sells those yUSD on Uniswap (see

section 4.4). yUSD of that maturity is currently trading at a discount—say, \$0.97—so she only receives 0.485 ETH. She deposits that ETH into her repo as additional collateral. She now has exposure to 1.485 ETH.

If Alice wanted, she could continue to take out yUSD, trade it for ETH, and redeposit the ETH as collateral, repeating until she reaches her desired amount of leverage or she bumps up against the margin requirement.

Since Alice’s repo has \$50 of debt outstanding and a collateralization requirement of 150%, it gets liquidated if the value of her collateral falls below \$75, which corresponds to the ETH price falling to about \$50.50. If someone liquidates her repo at that exact price, they will have to pay in 50 yUSD, and will receive \$75 worth of ETH collateral, giving them a profit of \$25, plus a little more based on the discount at which the yUSD are currently trading. If the price of ETH gets too close to her liquidation price, Alice should try to close her repo or deposit more collateral to avoid paying this penalty.

Suppose Alice holds the position until expiration. When it expires, \$50 worth of her ETH collateral will go to yToken holders, and the rest will go back to her. So if the price of ETH rose to \$200, yToken holders would receive 0.25 ETH of her collateral, and she would receive 1.235 ETH, worth \$247.

Alternatively, Alice can exit the position early at any time by purchasing yTokens (likely, though not necessarily, at less of a discount than she initially sold them for), and burning them to repay her debt.

Now suppose Bob wants to lend \$100 and earn interest on it until December 31, 2019. Bob can simply go to Uniswap and purchase yUSD. At the current discounted price of \$0.97, Bob’s \$100 can buy about 103.09 of these yUSD. At maturity, Bob’s yTokens will be redeemable for \$103.09 worth of ETH, so he will have earned \$3.09 in interest. If Bob wants to exit his position before that, he could do so by selling his yTokens (likely, though not necessarily, at a higher price than he initially paid for them).

#### 4.1.4 Applications of lending and borrowing

Most on-chain borrowing today involves borrowing “stable” assets, especially dollar-pegged assets like DAI or USDC [10], using ETH as collateral, and selling it for ETH. This would likely also be the most popular usage of yTokens. Indeed, creating a repo with ETH, minting yDAI, and selling it for ETH is quite similar to depositing ETH as collateral into Maker or Compound, taking out DAI, and selling it for ETH.

Another possible use case is shorting an asset that you think will decline in value. To short an asset ABC, you can deposit a stable asset (say, DAI) in a repo, mint yABC, and sell it.

For greater capital efficiency (though potentially greater risk), you can get a kind of “rehypothecation” by using interest-bearing assets like Compound’s cTokens [1], Fulcrum’s iTokens [6], or even other yTokens as a collateral asset. For example, you might prefer using cDAI—which represents an interest-earning claim on DAI from the Compound system—as collateral for your ABC short, rather than DAI.

## 4.2 Interest rate oracle

The price of a particular yToken floats freely, and is set by supply and demand. As mentioned in section 4.1.2, this means that yTokens will usually trade at a discount to their face value until expiration. This discount, along with the time to maturity, can be used to infer a *yield*—the annualized interest rate that would be earned by purchasing the yToken and holding it to maturity—in much the same way that you would infer an interest rate from the price of a zero-coupon bond.

Suppose yUSD that expire one year from today have a face value of \$1 but are currently trading at \$0.50. If you invested \$1 in those yUSD, you would be able to buy 2, and you would receive \$2 worth of ETH one year from today. Therefore, the yield on those yUSD (and the implied interest rate on the 1-year “loan”) is 100%.

There is a simple formula for computing the annualized yield  $Y$  on any yToken (where  $F$  is face value,  $P$  is present value, and  $T$  is number of years to maturity):

$$Y = \left(\frac{F}{P}\right)^{\frac{1}{T}} - 1 \quad (1)$$

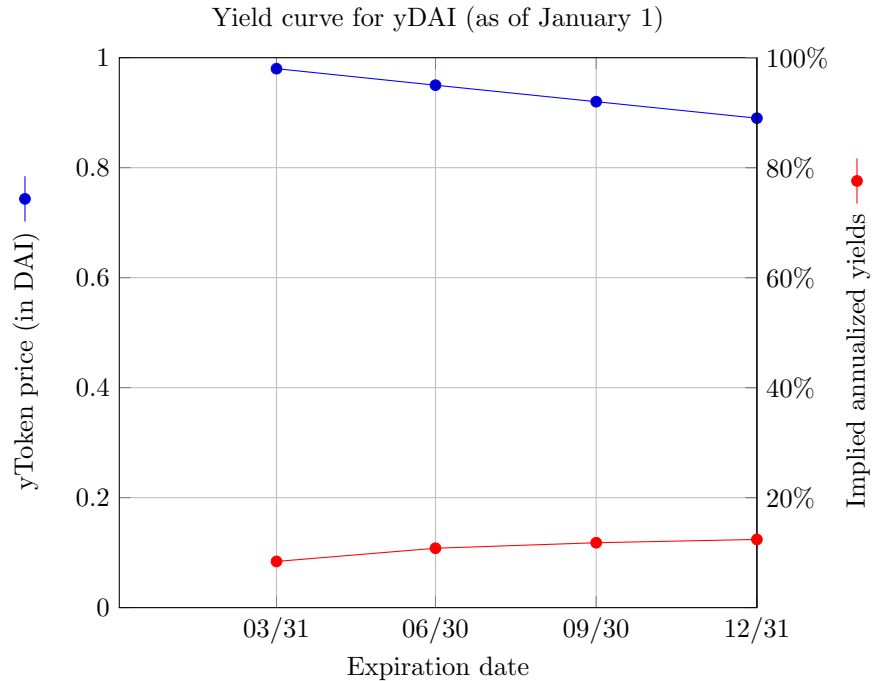
For example, in the above example, a \$1 yToken that expired in 3 months was trading at \$0.97. This price implied an annualized yield of  $\left(\frac{1}{0.97}\right)^{\frac{1}{0.25}} - 1$ , or about 13%.

The yield on short-dated yTokens could serve as an indicator of the “spot rate” for borrowing that asset. This could be used as an input to inform the choice of interest rate paid by protocols like Maker, Compound, and dYdX. If the price could be determined on-chain, it could be used to settle on-chain interest rate derivatives (such as swaps).

## 4.3 Yield curve construction

yTokens for the same underlying asset but with different maturities will likely trade at prices that imply different annualized yields. This should reflect the market’s expectations about how short-term interest rates will change over time—that is, the *term structure* of interest rates. (In practice, it will also be affected by other factors, including liquidity or the perceived risk of a bug in one of the smart contracts.)

You can graph the implied yields of different maturities of yToken for the same underlying asset, to create a *yield curve*:



The yield curve can be used to inform the governance of protocols like Maker and Compound, as well as providing potentially useful economic information to traders and analysts.

#### 4.4 Market making

The above applications depend on the existence of a liquid market in some yToken. Traders who want to profit from such a market could deposit liquidity into Uniswap [9], an automated market maker protocol.

Currently, Uniswap only supports pairs where one asset is ETH, but in the future, it will likely support arbitrary ERC20-ERC20 pairs. These will make it possible to market-make directly between yTokens and the underlying tokens (when those are ERC-20s), such as yDAI<>DAI. Providing liquidity to such pairs is relatively less risky, because you know what the relative prices of those assets will be upon maturity, so your losses as a liquidity provider are capped.

More sophisticated automated market makers might expand from merely trading yTokens to minting and burning them, or trading between yTokens of different maturities to arbitrage different yields.



## 4.5 yToken Sets

One drawback of yTokens, compared to other on-chain systems for borrowing or lending a target asset, is that they are not perpetual. To maintain a particular position indefinitely, a borrower or lender would have to regularly roll over their position, selling expiring yTokens and buying longer-dated ones.

Since many users might be interested in such a strategy, especially on the lending side, they might be able to pool their assets together and execute it on-chain. The full description of such a system is beyond the scope of this paper, but it could potentially be implemented as a Set token [11] that maintains a rebalancing basket of yTokens. Some strategies the portfolio might use include:

- Holding only yTokens that expire at the end of the current quarter, and rolling them over the day they expire.
- Targeting some *duration* (average time to maturity), and regularly rebalancing its portfolio to maintain that duration.
- Seeking to hold the highest-yielding maturities available, without regard to duration.

## 5 Alternatives to using a price oracle

As described above, the yToken contract sometimes needs to know certain facts about the price of the target asset. This is simple if the contract has continuous access to a synchronous cheap price oracle that provides the price of the target asset in terms of the collateral asset.

If no such oracle exists, there are alternative ways of constructing the contract, as described below.

### 5.1 What we need from our “price oracle”

The contract needs to learn something about the price of the target asset (in terms of the collateral asset) in the following cases:

- When yTokens are minted, the yToken contract needs to know that the repo is fully collateralized.<sup>3</sup>
- When someone attempts to liquidate a repo, the yToken contract needs to know that the position is undercollateralized.
- When a yToken is settled after expiration, the yToken contract needs to know the price of the target asset (in terms of the collateral).

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<sup>3</sup>Such a check also needs to be done when removing collateral from a repo. However, removing collateral from a repo is economically equivalent to repaying the debt, closing the repo, opening a new repo with the reduced collateral amount, and taking out the same amount of debt. The same rules can therefore be applied to both cases, so we only describe the rules in terms of taking out additional debt.

Note that for the first two categories, (*i.e.*, when determining whether someone should be allowed to withdraw yTokens, or determining whether a repo should be liquidated), the security of the system does not depend on an extremely precise measurement, because you can trade off capital-efficiency for precision.

For example, suppose you are only able to determine the relative price within a factor of 2. If you would otherwise have set the collateralization requirement to 150% (so a repo with \$100 in debt would be liquidated when the collateral was worth \$150), you can set the requirement to 300% instead, and give yToken holders the same level of protection against gap risk. (Repo creators would likely want to maintain at least 600% collateral, to avoid the risk of getting unfairly liquidated.)

### 5.1.1 Asynchronous or expensive price oracles

If the price oracle is asynchronous (like UMA’s Data Verification Mechanism [12]), or expensive to use, it may be impractical to use it every time a repo is created or liquidated.

There are some optimizations that could reduce the number of calls to the oracle (although they may require setting larger collateralization requirements to maintain the same level of safety). To sketch out some of them:

- When a repo is liquidated, instead of calling the price oracle, the liquidator could put up a security deposit. The repo’s owner can then cancel the liquidation and claim the security deposit by calling the oracle and proving that the repo was fully collateralized. If the liquidation has not been cancelled within 24 hours, the liquidation completes.
- When yTokens are minted, the creator could either call the price oracle, or choose one of the following alternatives:
  - Point to an existing repo for the same yToken with an equal or lower liquidation price, that is not in the process of being liquidated. The existence of such a repo implies that the liquidation price has not been reached.
  - Initiate a withdrawal of new yTokens, then wait 24 hours. During that waiting period, anyone can initiate a liquidation of the position if it is undercollateralized (based on the *post-withdrawal* quantity of collateral). Once the waiting period is over, if no such liquidation is in progress, the withdrawal completes.

## 5.2 yTokens with physical settlement

If the target asset is itself an ERC20 token on the Ethereum blockchain, you can construct yTokens in a way that does not depend on an externally provided price oracle.

### 5.2.1 Preventing undercollateralization

There are many plausible ways to construct an imprecise relative price oracle for ERC20 tokens. One possibility is to use Uniswap as a price oracle. In Uniswap version 1, this oracle would be relatively easy to manipulate, but future versions of Uniswap are expected to provide a hardened price oracle.

Another possibility is to use an on-chain exchange that tracks the length of time that a particular offer is open. A long-lived offer to trade the target asset for the collateral asset can be used to infer a lower bound on the target asset's price, and can therefore be used to liquidate a repo.

### 5.2.2 Settlement

The price oracles described above would not be precise enough to use for settlement. Fortunately, there is an alternative way to ensure correct settlement: an auction. For each repo that has outstanding debt, the collateral of that repo can be sold in a reverse Dutch auction to repay that debt. For example, suppose an expired repo has 1 ETH in collateral and 100 yDAI in debt outstanding. The protocol would offer anyone 0.01 ETH in exchange for 100 DAI, gradually raising that offer over time until someone accepts.<sup>4</sup> The remainder of the collateral would be returned to the repo creator, while the tokens collected in these auctions would be distributed to yToken holders.<sup>5</sup>

One advantage this mechanism has over cash settlement is that after this auction, assuming it is successful, each yToken will be fully backed by the target asset, rather than being backed by some amount of the collateral asset. This means that yToken holders will maintain the same exposure to the target asset without having to take any action themselves (though they will no longer be earning a yield on it), and can redeem it at their leisure.

## 6 Future work

As mentioned in section 4.2, there are likely some interest rate derivatives that could use yToken prices as an oracle. These might be useful for expressing a view on the future path of interest rates, or for hedging duration while holding yTokens or owning a repo.

The physical settlement system described in section 5.2 could likely be adapted to create Bitcoin futures on Ethereum, adapting ideas from Summa [13] and tBTC [14] (such as using an SPV-proof-based orderbook for a price oracle for proof of undercollateralization, and using SPV proofs to enforce physical settlement).

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<sup>4</sup>The repo holder could short-circuit this process by either repaying their yToken debt or by accepting the auction's offer themselves.

<sup>5</sup>If the collateralization requirement was high enough that the repo does not become undercollateralized during this process, we would expect all of these auctions to complete successfully. If some of the collateral remains unsold when the auction is done, that collateral could be distributed to yToken holders along with the physical assets.

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