RFC - Fund Completion of CEX->DEX Incentive Research

Abstract

This proposal aims to refine the work of the ARDC's CEX to DEX incentive research and create a pilot program that focuses on migrating derivative traders from CEX to DEX. This initiative was formerly led by @Immutablelawyer , @Gaboss , and ARDC members and their research focuses on creating incentive campaigns at the network level.

We believe completing this research is the best way to create a targeted incentive program that provides flexibility for protocols while the DAO is still able to maintain oversight. Additionally, protocols and teams have stated the need for more flexibility and long term alignment as recently as last week's incentive detox public call.

"DAO incentives need to have more flexibility to align long-term goals" ~Darius from Vertex

Problem:

1. Rigid Use of Incentives

: The current status quo relates to incentives and has been a one size fits all. Resulting in mixed success among protocols that deployed incentives.

1. Technical barriers

: Most products specialize either in CeFi or DeFi and there are few solutions to help link the two ecosystems.This showcases the lack of integrations and standards seen in other industries.

1. Communication

: there has been a lack of mechanisms to target this user base directly to funnel them to Perp DEX Products, with strong and long-term incentive programs, ensuring the retention of this liquidity on the DeFi side.

Goal:

To complete research and create network level incentives focused on migrating traders from centralized exchanges ("CEXs") to on-chain derivative protocols within the Arbitrum network. The desired outcome being to create a sustainable process that (i) attracts traders from CEXs and (ii) retain traders within the Arbitrum ecosystem (iii) limits dilution of Abritrum.

Moreover, by focusing on migrating more volume and TVL into perpetual exchanges on Arbitrum we have the potential to create a transaction multiplier. Many traders, prop shops and market makers need to hedge, transfer assets from one account to another, utilize lending/borrowing services, etc etc. The increase of these transactions is not linear, it is exponential. This means more volume, more sequencer fees, and more value accrual for the Arbitrum ecosystem. Completion of the research and eventual pilot program aims to quantify this and create a repeatable process.

The working group will conduct work based on three phases: complete ARDC's research, standards creations, and implementations with DAO support. The research phase will focus on interviews with institutional traders/power users, protocols teams, analysis of similar cold start incentive programs. Based on these finding guidelines and standards will be created for network based incentives for perpetual platforms. The last step is to bring a formal proposal to the DAO, that includes KPIs and a clear path towards growth for Arbitrum perpetual futures.

Motivation

"Show me the incentive, and I will show you the outcome" - Charlie Munger.

In contrast to prior incentive programs that have been conducted such as STIP and LTIPP, the focus will be on network-wide incentives that will be tailored towards aligning the long-term interests of the DAO directly with traders, rather than leaving the responsibility with the protocols themselves. As outlined in this forum post, even though prior approaches resulted in a program with less of an operational load, leaving decision-making in the hands of those with the greatest domain expertise, this also brought about a number of challenges.

This was corroborated by StableLab in their report analyzing STIP and LTIPP whereby they found that these incentive programs "struggled to retain users, with activity levels returning to pre-STIP figures". Rather than bring about real sustainable growth, such incentives instead attracted mercenary capital, as seen by the significant drop-off in trader volume and activity following the end of the incentive program.

Rationale

The Opportunity

Messari in this report referred to perpetual futures as "arguably crypto's stickiest innovation, as well as being the most capital-efficient instruments in crypto, generating the most revenue by market cap." This highlights the value of focusing on derivatives given that they can offer a significant source of volume during adverse market conditions, which in turn help to maintain the value of the ARB token and subsequently the DAO treasury itself.

This report may seem stale as it is nearly a year old but the trend of growth among perpetual futures continues. The Arbitrum ecosystem is currently the second leading derivatives chain. And has done nearly 20% of cumulative volume of all perpetual future platforms.

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Throughout 2024, as of 29-Sep-24, Arbitrums' daily derivative volume (DefiLlama) has ranged from $605 million up to $4.15 billion. For perspective, even if we take Arbitrum's daily derivative volume at its peak, it is a fraction of the average daily March derivative volume of $140 billion(~3%) with a vast majority of the total derivative volume currently occuring on centralized exchanges.

Migration barriers

In attempting to attract traders from CEX we must first understand the appeal of CEXs. These include:

Centralised Exchanges

Arbitrum-based DEXs

User Experience

CEXs provide a user-friendly interface and seamless trading experience

This is an ever-improving component of DEXs of which Arbitrum has already contributed indirectly towards, via the allocation of funds to DEXs in STIP and LTIP.

Liquidity

Deep liquidity pools ensure minimal slippage and efficient trade execution.

Liquidity incentives have been and will continue to be implemented to ensure substantial liquidity.

Advanced Trading Features

Availability of margin trading, futures and other derivative products.

An increasing number of DEXs are beginning to offer more complex financial products.

Customer Support

Reliable customer support for troubleshooting and assistance.

More challenging to compete with CEXs given their centralised nature.

Security & Trust

Established reputation and perceived security.

To build trust in the Arbitrum ecosystem by whitelisting DEXs and engaging industry leaders to carry out risk management of the incentives being rolled out.

The derivative exchanges currently positioned as market leaders include Binance, Bybit and OKX, who all charge maker fees of 0.02%, while taker fees amount to 0.04%, 0.055% and 0.05% respectively.

In addition to the above, individuals trading on CEXs also face a strong degree of friction to transition over to a DEX. These include:

1. Inefficient on-ramp solutions: For traders to onboard themselves to a specific chain they must either (i) use a bridge which tends to be slow, has high fas fees, requires assets to already be on-chain (ii) use a FIAT on-ramp which tends to have high fees (2% - 5%), custodial and brings limited liquidity from smaller investors (iii) withdraw from a CEX.

2. Lack of fluidity between CeFi and DeFi apps: Most products specialize either in CeFi or DeFi and there are few solutions to help link the two ecosystems.

Unequal crypto liquidity distribution: Currently 90% + of crypto liquidity is in CEXs. Given that users already have their liquidity onboarded on a CEX, protocols have limited options to incentivise users to transition to DEXs.

Specifications

Research Phase:

- Conduct comprehensive interviews with institutional traders and power user of perps platforms
- Goal to understand the barriers for CeFi users
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- Conduct interviews with protocols to understand their limitations (resources, UX/UI, tech, etc)
- Analyze historical data from previous cold start incentive programs to identify successful strategies and areas for improvement.

Standards and Integration Guidelines:

- Develop targeted protocol standards based on research findings, focusing on the specific needs and preferences of CeFi users.
- Identify services/tools that can be used to track and facilitate the transition of traders from CEXs to DEXs.
- Utilize best practices frome research by ARDC and working group to create framework that rewards network wide metric growth

Arbitrum Community:

- Establish clear Key Performance Indicators (KPIs) and milestones to measure success and guide adjustments.
- Launch a pilot incentive program with a controlled budget to test the proposed strategies and gather initial performance data
- Implement bi-weekly and monthly reporting mechanisms to monitor progress and make necessary adjustments in real-time.
- Tested and adjusted based on performance data and market conditions.

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Overall Cost

185,000 ARB

Cost Breakdown

Four working group members paid $7,500 per month.

Three months of work

- 1.5 months for interviews and ARDCs initial research,
- 1.5 months for proposal creation and feedback, modification
- 20-30 hours per week

4 x 3 x $7,500 = $90000 (185,000 ARB at current prices)

Team

We’re inviting skilled individuals to join the working group, particularly those with expertise in on-chain research, data analytics,project management, community management or incentive campaigns. Experience in derivatives trading, both technical and non-technical, is a plus. If there is strong interest in joining, we may introduce a formal application process to ensure a thorough review of all candidates.

Closing Thoughts:

The CEX to DEX initiative has been discussed and researched for nearly a year. ARDC,@Immutablelawyer , @tnorm , multiple delegates and protocols have clearly showcased the need for a network level incentive program like the CEX to DEX incentive program. The program aims to give the DAO the control it needs while creating a fair and efficient distribution of incentives to protocols based on clear objectives.

It will be the job of the CEX to DEX working group to clearly define these objectives to help migrate traders from CEXs to DEX. Using tools like boost, cede.store and others, we can conduct experiments smoothly and enable open access to campaign and incentive objectives. Starting simple at first and growing in complexity over time.

Acknowledgment

Huge thank you to the Immutable Lawyer, Tnorm, Alex Lumley, and members of the ARDC for all the previous work, research and feedback.