Written by IOSG Ventures (Momir & Henry | Data Analysis by Darko)

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TL;DR:

- Problem: Arbitrum's incentive programs have failed to deliver sustainable growth, with TVL and trading volumes of incentivized protocols reverting to pre-incentive levels. Past proposals lacked a cohesive strategic vision, relying on ex-ante rewards for individual projects often misaligned with the ecosystem's best interests.
- Why Now? Arbitrum faces mounting competition, especially from Base, with Solana and BSC also growing much faster. Arbitrum's mindshare has been on the constant decline, making this a critical moment to strengthen network effects and reverse the negative trend.
- Objective: Re-establish Arbitrum as the leading DeFi hub by building deep liquidity, attracting high-demand assets, and creating a flywheel of liquidity, trading volume, user retention, and innovation.
- Guiding Question: How can we ensure that users never feel the need to leave Arbitrum? The answer lies in strengthening the spot market as the ecosystem's backbone.
- Core Strategy:
- Deepen liquidity for blue-chip assets and stablecoins.
- Expand token diversity to meet user demand and attract new projects.
- Implement a KPI-driven, ex-post rewards framework, distributing incentives directly to liquidity providers based on performance.
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- Required Services: Successful execution requires support from:
- A cross-chain bridge solution (e.g., deBridge, Wormhole) to onboard diverse assets.
- A data analytics provider (e.g., Kaito AI) for insights on token prioritization and market trends.
- A service provider (e.g., Brevis) to ensure fair and verifiable reward distribution.
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The Failure of Current Incentive Schemes

Since November 2023, Arbitrum DAO has deployed over 116.4M ARB tokens for short and long-term incentive programs aimed at boosting user engagement, trading volume, and Total Value Locked (TVL) on its network. While these programs demonstrated positive short-term impact, they have largely failed to sustain growth, with TVL and volume metrics regressing to pre-program levels.

A prime example is GMX, the largest grant recipient, which received 12M ARB (~$18M at $1.5 per token). Despite allocating the majority of these funds toward maximizing TVL to ensure sufficient liquidity in their Automated Market Maker (AMM), the protocol has struggled to maintain long-term growth. This is evidenced by their TVL declining from approximately $480M to $380M—a 20% decrease—in the post-incentive phase.

Similarly, MUX protocol, the second-largest recipient with 6M ARB in incentives (~$9M at $1.5 per token), has shown concerning sustainability issues despite focusing on fee rebates. Their current TVL of approximately $30M represents a significant decline from their pre-incentive level of ~$48M (-37.5%). More worryingly, their daily trading volume has plummeted from a healthy range of $100-200M to merely $20M.

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Source: OpenBlock Labs

Ironically, verticals that received less incentives had comparatively better growth metrics compared to the biggest grantees. For instance:

- CDP vertical saw a ~210% increase in TVL post-incentive.
- Lending experienced a ~610% increase in lending volume after receiving incentives.
- Unicorn like Pendle was NOT in the Top 5 grant receiver (7th) but it has achieved a 11.3x increase in TVL, significantly contributing to the Arbitrum ecosystem.

These figures suggest that there might be a more effective way to distribute resources within the Arbitrum ecosystem.

The Politics of Arbitrum & Unintended Consequences

The poor incentive program has also resulted in negative externalities.

Through our interactions as a venture capital firm, we have encountered numerous projects that opted against launching on Arbitrum, despite its position as the L2 with the deepest liquidity. These projects consistently cite concerns about market dynamics where established protocols have disproportionate influence through substantial ARB grants, which they use to attract users through incentive programs. This environment creates an uneven playing field where potential new entrants are pushed to other ecosystems like Base.

A Strategic Reset: Aligning Incentives with Growth

Arbitrum's path forward should focus on maximizing potential MEV value capture through its core strength - the DeFi ecosystem. Rather than scattering resources, ARB governance must focus the incentive programs on strengthening this foundation and amplifying network effects.

The current approach of distributing ARB tokens ex-ante through subjective grant programs has proven inefficient. Instead, Arbitrum should come up with a metric-driven framework where rewards directly follow results. Projects should earn incentives by achieving specific, measurable objectives that benefit the entire ecosystem.

Why now?

The competition among L2s has never been more intense, and we believe that changes are necessary at this very moment due to the following reasons:

1. Base, BSC, and Solana have surpassed Arbitrum by generating larger on-chain spot volumes in the past 90 days. Arbitrum needs to strengthen its network efforts to build up its defensibility.

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Source: Artemis.xyz, 2024.11.27.

1. Arbitrum spot volumes have dropped sharply as a percentage of Ethereum on-chain volumes, reflecting the fading demand to trade on Arbitrum and an urgent need for a better strategic incentivization program.

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Source: IOSG

1. Blob has brought down gas fees on L2s and provided a valuable and perfect window for layer 2 solutions to attract liquidity, users, and capital from Ethereum.
2. Arbitrum Orbit has been losing the race to OP stack and currently Arbitrum's main battle is to ensure its main chain remains the most dominant integrated DeFi hub on Ethereum.

3. The overall decline of interest in Arbitrum can be reflected in its mindshare compared to the overall market (Including other L2s).

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Source: KaitoAI

Incentive Principles

In analogy to Web 2.0 mantra of “people, product, profit”, Web 3.0 projects also need simple guidance principles. In the case of chains looking to build an ecosystem we believe that the paradigm should be - users, ecosystem, MEV.

Any strategic initiative must be grounded in comprehensive user analytics, addressing fundamental questions:

- Who are our most valuable users?
- What attracts them to Arbitrum?
- What challenges do they face?
- How can we create an ecosystem where they never need to leave?

The proposed growth framework operates as a self-reinforcing system, beginning with comprehensive user analysis and service optimization. This foundation attracts high-calibre projects to the ecosystem, fostering healthy competition in serving user needs. As these projects optimize their offerings, they generate sustainable MEV through organic user activity, creating a virtuous cycle where enhanced user retention drives ecosystem value. This increased value, in turn, attracts both additional users and innovative projects, perpetuating the growth cycle and strengthening Arbitrum’s network effects.

Who are Arbitrum’s users?

Identifying the most valuable user group of Arbitrum is a relatively straightforward task. Arbitrum managed to attract a significant number of whales (users that trade more than $100k daily) from Ethereum and nowadays whales generate 90% of Arbitrum’s on-chain volume. This is approximately in line with whales contribution to on-chain volume on Ethereum.

Through observing the trading behaviour of Arbitrum whales, we have identified two key patterns:

I) Arbitrum whales still trade on Ethereum because they need deeper liquidity.

Below is a table showing the trading behaviour of Arbitrum whales. As illustrated these users simultaneously trade on both Arbitrum and Ethereum. For the most popular and in-demand trading pairs, the average trading size is significantly larger on Ethereum than on Arbitrum, reflecting that part of the reason Arbitrum whales are trading on Ethereum is due to deeper liquidity.

Moreover, stablecoins, in particular, have the most significant disparity, which also suggests that Arbitrum currently lacks stablecoin liquidity.

Token Pairs (90D)	When trading on Arbitrum	When trading on Ethereum
Stablecoin-WETH	1.6K	4.9K
Stablecoins	2.8K	95.0K
WBTC-WETH	3.1K	

17.8K

Stablecoin-WBTC

2.1K

8.6K

ARB-WETH

1.4K

2.1K

Source: IOSG Ventures

II) Besides the demand for deeper liquidity Arbitrum whales leave Arbitrum only for the reasons of getting exposure to more diverse tokens.

Over the last 90 days, Arbitrum's leading traders generated almost$37.67B in volume on Arbitrum versus $1.86B in volume on Ethereum, showing that whales are typically loyal to Arbitrum and only moving to Ethereum for trades due to the necessity for deeper liquidity and diversity of token choices, including the recent trends such as memecoins etc. These same users have interacted with about 3500 tokens on Ethereum mainnet and 800 tokens on Arbitrum mainnet over the recent three months, further supporting the hypothesis that Arbitrum whales demand more diversity.

Introducing Proposal Arbitrum Summer (working name)

Arbitrum Summer aims to develop the ecosystem such that its most valuable users never have to leave the chain.

In principle Arbitrum Summer significantly differs from previous incentives schemes:

Arbitrum Summer

Previous Incentive Schemes

Reward criteria

Ex-post

Ex-ante

Ecosystem strategy

Top down

Bottom up

Strategy

Nurturing ecosystem & network effects

Rewarding influential players

Primary focus

Users

Projects

Project participation

Anyone from a given category

Those with political influence

Discriminates against new projects

No

Yes

Beneficiary vertical

DeFi, spot market

Unfocused

Empirical results

Untested

Poor

Focus on spot market

Arbitrum's governance strategy should mirror the proven business model of successful exchanges. Just as leading exchanges prioritize their highest-value users, Arbitrum must focus on providing two fundamental elements: deep liquidity and access to high-demand assets in the spot market.

While comprehensive functionality—including lending, leverage, and derivatives—remains important, data reveals the primacy of spot markets. Analysis of the top 1,000 Arbitrum traders shows that only 39 actively engage with borrowing protocols, underscoring where user priorities truly lie. This insight suggests a clear strategic sequence: establish robust spot markets first, as they form the foundation for broader ecosystem development.

This approach creates a natural progression: deep, efficient spot markets attract complementary DeFi protocols, which then build around this core liquidity. Like a successful exchange, Arbitrum's growth should follow this tested path—starting with excellence in spot trading before expanding into more complex financial instruments.

Dynamic framework

The proposed distribution model shifts ARB token incentives from protocols to liquidity providers directly. Eligibility criteria for participating DEXs would be strictly defined: platforms must demonstrate sustained stability with a minimum TVL of $10M over six consecutive months. This approach ensures that only battle-tested protocols serve as venues for liquidity provision to avoid driving new capital into untested smart contracts.

Implementation Strategy

1. Direct rewards to liquidity providers who supply specific assets to qualified DEX pool
2. Initial focus on deepening liquidity for:
3. Stablecoin pairs
4. Established, high-volume tokens
5. Dynamic token inclusion based on emerging market demand
6. Consider for extra rewards if the in-demand tokens are paired with ARB in liquidity pools
7. Automated reward adjustment via bonding curve mechanics:
8. Higher rewards during initial liquidity building phase
9. Gradual reduction as liquidity depth approaches target levels
10. Automatic tapering once key metrics (depth, volume, spreads) meet predetermined thresholds

To ensure data-driven decision making, partnership with a professional analytics platform is essential. Kaito's analytics suite could provide valuable insights for identifying tokens that command significant market attention and trading volume. Additionally, this framework necessitates collaboration with a strategic bridging solution to facilitate seamless asset transfers, particularly for newly incentivized tokens.

Different from previous incentive programs, this incentive program distributes rewards directly to liquidity providers instead of projects/business entities. Direct distributing ARB rewards to end users from the Arbitrum Foundation may trigger fairness ,security and compliance concerns. To make the program fully trust-free, we propose to build a trust-free Continuous Liquidity Incentivization system powered by Brevis ZK Coprocessor. With this system, Arbitrum Foundation only needs to allocate a certain amount of ARB tokens to a reward distribution smart contract and an LP will be able to claim their rewards when they successfully verify a self-generated ZK Proof of its historical liquidity contribution score to Arbitrum. This allows the program to run in a fully decentralized, transparent and trust-free fashion. Other projects are adopting similar systems such as Usual Money's continous protocol incentive system.

Target

Boost stablecoin and short-tail asset liquidity as well as the liquidity of assets that trend on mindshare metrics

Cooperation requirements for successful execution

Data analytics provider (e.g. Kaito) and bridge provider

Reward distribution

Directly to LPs of eligible spot DEXs according to the specific weights of the dynamic framework

Eligible spot DEXs

Consistently more than $10M TVL over a 6 month period

Fly-wheel effect

Through this framework, we aim to establish a flywheel effect:

1. Arbitrum obtains the deepest liquidity and broad coverage would make a best product for the target customers, incentivizing them to increase exposure to the ecosystem.
2. With increased liquidity, volume, and users in the Arbitrum ecosystem, it attracts more developers and new projects to build on Arbitrum, offering greater diversity natively.
3. The deep liquidity in the spot market supports a strong foundation for other DeFi verticals.
4. The successful ecosystem provides greater room and opportunity for experimentation and exploration of new verticals, propelling Arbitrum to new heights.

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Conclusion

We believe the proposal would be the key to fostering a strong DeFi ecosystem, attracting new users and projects to build on the ecosystem and subsequently motivating users to remain loyal to the chain thanks to the ample amount of resources and liquidity on Arbitrum.

As competition from other L2 intensifies, the Arbitrum community must adopt a new approach to maintain its dominant position. We believe that the past incentive programs have serious misalignments and misuse of resources that hinder newcomers from joining, and causing users to lose interest in Arbitrum.

To keep users within the Arbitrum ecosystem, we must focus on attracting the “right” liquidity, where a low-slippage environment can encourage user stickiness while driving the growth of the economic flywheel. This, in turn, strengthens the network effects that are crucial to defending Arbitrum’s dominance from any challenges from all the L2s.

APPENDIX

More detailed implementation plan

To enhance Arbitrum’s liquidity ecosystem and attract high-value assets, we propose the following structured approach:

1. Monthly Epochs: Conduct incentive distribution on a monthly basis, enabling regular evaluation and adjustments.
2. Dynamic Point Distribution: Allocate dynamic reward points across asset categories such as:
3. Stablecoins (objective: improve liquidity depth for Arbitrum whales)
4. Blue-chip assets (objective: improve liquidity depth for Arbitrum whales)
5. High-mindshare assets (objective: offer more diversity for Arbitrum users)
6. Incentivize Arbitrum-Paired Liquidity: Offer additional reward multipliers for tokens paired with Arbitrum in liquidity pools, fostering ecosystem integration.
7. High-Mindshare Asset Monitoring: Maintain a dashboard, managed by Kaito, to identify and prioritize high-mindshare assets that Arbitrum should target for each epoch.

8. Bridge Support for Non-EVM Assets: Collaborate with cross-chain bridges like Wormhole/deBridge to onboard assets from non-EVM ecosystems swiftly. DAO could provide the requirements and let different cross-chain bridges that satisfy requirements bid (examples of requirements: at least X months of operating time without security incident, at least X amount of volume facilitated, ability to introduce new assets in less than 24 hours upon receiving the request from DAO, etc.)
9. KPI-Based Reward Adjustments: At the end of each epoch:
10. Evaluate whether target KPIs for each category are met.
11. Adjust rewards accordingly:
12. Reduce the rewards in the next epoch for categories that achieve their target levels.
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14. For existing assets (stables and blue chips), measure KPIs as the market share of traded volume pre- and post-incentive implementation. While not ideal, this metric provides a baseline for assessment.
15. For high-mindshare assets, KPI measurement could be based on their share of Arbitrum's on-chain trading volume (e.g., [target asset volume / total Arbitrum volume]). If these target assets don't capture X% of Arbitrum on-chain volume in the first few months of the incentive period, the incentive scheme would be classified as failed and recommendation to stop it shall be issued.
16. Professional KPI Analysis and Formula Design: Engage professional service providers like Gauntlet to define precise KPI measurement methodologies and develop an optimal reward distribution formula.

Proposal integration requires support of several entities:

- Cross-chain bridge (non-EVM support required)
- Kaito analytics (they have industry standard for mindshare analytics that should drive the decision of what assets should be incentivized)
- Brevis to implement the dynamic algorithms of distributing the rewards in a fair and verifiable fashion
- Consulting a service provider that could develop exact formulas for measuring KPIs according to the above objectives