



Trader Joe

Joe Dex v2.0: Liquidity Book

V1.0

June 2022

Abstract:

We introduce Liquidity Book (LB), a novel protocol for structuring liquidity in a decentralized exchange. The LB protocol enables the creation of unique and dynamic liquidity structures for a paired asset market. Liquidity is pooled in constant price bins which are aggregated to establish a market.

1 Introduction

Trader Joe (v1) was launched in 2021 as an AMM with Uniswap v2 liquidity contracts as its backbone [1]. As DeFi advances, we have concluded that capital efficiency and liquidity flexibility are urgent issues that demand protocol development. In this paper, we present our design for the next stage of the JOE decentralized exchange.

1.1 Concentrated Liquidity

Tick bound liquidity, as implemented in Uniswap v3 (v3), pioneered the concept of concentrated liquidity for a general automated market maker (AMM) [2]. In Uniswap's implementation, individual liquidity positions are established which provide reserves over a restricted price range. The reserves of each position are exchanged over its price range following a common constant function formula. This common function allows individual position reserves to be aggregated together to form the market.

Even before the concentrated liquidity term was coined, StableSwap/Curve provided a similar solution for stable exchange rate reserves. Curve v1 utilizes an invariant curve with an implied static peg [3]. While the liquidity is unbounded, the bulk of reserves concentrate liquidity around the peg price. Curve v2 introduces a more general solution using an internal price oracle to upgrade to a dynamic peg [4].

Constant function algorithms used in Uniswap and Curve limit the ability of liquidity providers to deploy tailored market making strategies. We propose a new protocol with Discretized Concentrated Liquidity to provide flexible infrastructure layers for market participants. Discretized Concentrated Liquidity has been previously presented by the iZiSwap for their limit order implementation [5].

1.2 Liquidity Book

The Liquidity Book (LB) arranges liquidity of an asset pair into discrete price bins. Reserves that are deposited into a liquidity bin are available to be exchanged at the constant exchange rate (price) that is defined for the bin. The market for the asset pair is constructed by aggregating all of the discrete liquidity bins. For example, a market liquidity structure supplied by different market participants (color coded) could be represented by the figure below.

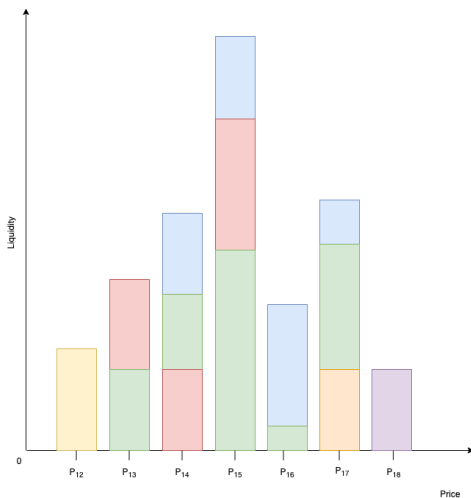


Figure 1: Example Liquidity Structure

2 Protocol Design

2.1 Reserve Pricing

Following AMM convention, price (P) is defined as the rate of change in Y reserves per change in X reserves.

$$(2.1) \quad P = \frac{\Delta y}{\Delta x}$$

Stated another way, price represents the value of X assets in Y terms.

2.2 Bin Liquidity

Liquidity (L) is defined to be the nominal value of reserves deposited into a discrete bin denominated in Y terms. Liquidity is conserved as the bin's reserve composition changes and can be described in Eq 2.2 as the value sum of its composite assets.

$$(2.2) \quad P_i \cdot x + y = L$$

Each individual bin is a constant sum market with its own unique bonding curve. The bin's curve is fully defined by the price parameter of the bin (static) and the total liquidity reserves deposited into the bin (dynamic). As shown in Figure 2, the y intercept represents the bin's total liquidity (L) while slope is defined by the bin's price (P_i).

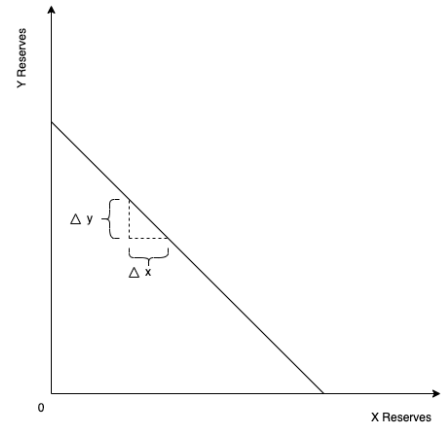


Figure 2: Reserve Bonding Curve

2.3 Bin Composition

Due to the design above, the composition of reserves in a liquidity bin is independent of both price and liquidity. An additional variable can be used to describe the reserves available in a bin. This variable, composition factor (c), will be defined as the percentage of bin liquidity that is composed of Y reserves. Composition (c) is bounded by [0,1].

$$(2.3) \quad c \equiv \frac{y}{L}$$

Asset reserves of each liquidity bin are fully defined by bin liquidity, L, and composition, c, as shown in Eq 2.4 and 2.5.

$$(2.4) \quad y = cL$$

$$(2.5) \quad x = \frac{L}{P_i} (1 - c)$$

An example composition of X and Y reserves in a liquidity bin can be visualized as shown in Figure 3.

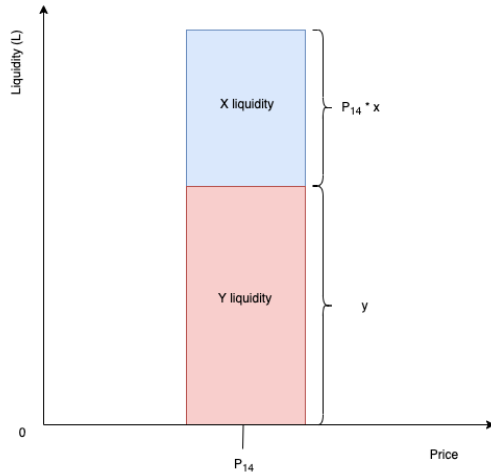


Figure 3: Bin Reserve Composition (P_{14} bin)

2.4 Market Aggregation

Aggregation of individual liquidity bins for an asset pair establishes the market for that pair. The reserve state of liquidity bins is expected to transition between X reserves and Y reserves as market pricing changes. Liquidity bins that are priced below market will contain only asset Y and liquidity bins priced above market will contain only asset X. Market price is therefore determined to be the lowest price bin containing X reserves.

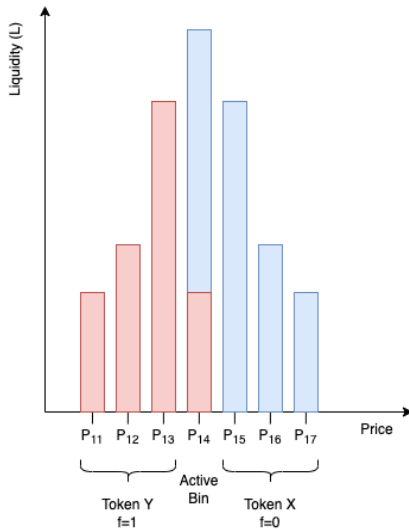


Figure 4: Aggregate Liquidity Composition

2.5 Market Making

With discrete liquidity bins, liquidity providers are able to create custom liquidity structures that allow them to easily manage their positions according to their individual objectives, projections, and risk profiles. A liquidity provider can concentrate liquidity around certain price points or spreads and adjust individual liquidity bins without impacting their liquidity positioning in other bins. Overall, the liquidity book design allows for the fine tuned range and depth adjustments that market makers require to operate successfully.

3 Protocol Architecture

3.1 Bin Price

Each market (pair contract) will have a total of 2^{24} (16777,216) liquidity bins. Bins will be assigned an integer identifier (i) that ranges between $[0, 16777215]$. The price prescribed to each bin will be a function of the pair's bin step (s) and the bin's identifier (i), as shown in Eq 3.1. The bin step (s) is a fixed parameter that is defined when a pair is created. This parameter determines the constant percentage increase ($i > 0$) or decrease ($i < 0$) in price between each incremental bin.

$$(3.1) \quad P_i = (1 + s)^{i-8388608}$$

Following Eq 3.1, the centrally located bin, $i=2^{23}$ (8388608), is assigned the value of price parity ($1X=1Y$). This establishes a roughly equal division of bins where the value of X is less than Y vs greater than Y. With a defined limit on liquidity bins, the full range of pricing available for the market is a function of the selected bin step. For example, a market with a bin step of 0.00001 (1/10 bp) will have a price range of $[3.71 \times 10^{-37}, 2.70 \times 10^{36}]$.

3.2 Liquidity Tracking

To optimize liquidity tracking, bins are indexed in a tree that is created by nesting three 256 bit arrays as depicted in Figure 5. In this tree, each bin is assigned a location path through the nested arrays. When a bin contains liquidity, a non-zero value is assigned to the three array elements that represent the bin's location.

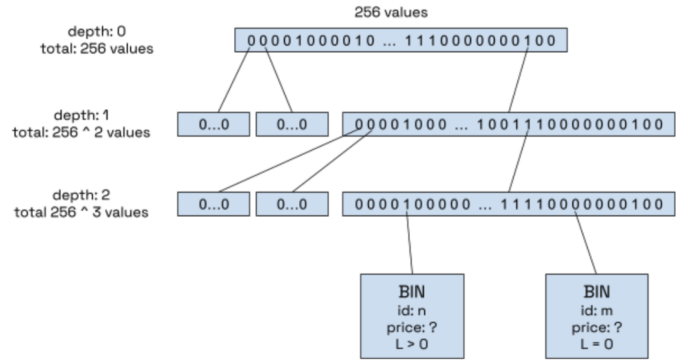


Figure 5: Bin Index Tree

Using the tree above, the liquidity state of the market can be efficiently searched during swapping or monitored externally.

3.3 Trade Routing

The LB router will provide added security and slippage checks for swaps and liquidity deposits/withdrawals. Swaps will also be routed through legacy AMM pairs when better pricing is found.

3.4 Liquidity Tokens

A new liquidity token standard has been developed specifically for the LB protocol to support the large quantity of bins in each market. By design, liquidity (L) in an LB market is composable across bins since it is commonly valued in Y terms and is independent of the state of the bin. Therefore, the liquidity receipt token, LBToken, will carry an equal liquidity value irrespective of the bin it is contained in. This property enables bin liquidity to be seamlessly bundled together across bins.

LBTokens will essentially resemble legacy ERC-20 liquidity tokens with the following key difference: they are assigned an id when minted that matches the bin identifier (i) where the liquidity resides. The LBToken contract follows the ERC-1155 multi-token standard except that it is restricted to containing fungible ERC-20 tokens.

LBTokens are fungible, price-located liquidity receipt tokens.

4 User Interactions

4.1 Add/Remove Liquidity

Adding and removing liquidity to/from an active liquidity bin will conserve the price (P) and composition (c). For a given liquidity adjustment, the required quantity of reserve X and reserve Y can be calculated using Eq 4.1 & 4.2 below.

$$(4.1) \quad \Delta L = \frac{P}{(1-c)} \Delta x$$

$$(4.2) \quad \Delta L = \frac{1}{c} \Delta y$$

For all 'inactive' liquidity bins, liquidity can be added exclusively in reserve X or reserve Y as determined by the composition bounds.

$$(4.3) \quad \Delta L_{c=0} = P \cdot \Delta x$$

$$(4.4) \quad \Delta L_{c=1} = \Delta y$$

4.2 Swaps

Exchanging reserves within a liquidity bin will conserve liquidity and price, therefore only reserve composition will change. Reserves are exchanged following Eq 4.5 while the composition remains in its bounds of [0,1].

$$(4.5) \quad \Delta y = -P \Delta x$$

The reserves that are available in the liquidity bin until the composition bounds are reached can be calculated following Eq 4.6 and 4.7.

$$(4.6) \quad \Delta c = -\frac{P}{L} \Delta x$$

$$(4.7) \quad \Delta c = \frac{1}{L} \Delta y$$

When a swap requires more liquidity than is available in the current bin, the swap will exhaust the liquidity in each consecutive bin before moving to the next adjacent bin with liquidity.

4.3 Swap Fees

Fees will be collected by the protocol to compensate liquidity providers for the trading activity that occurs. The total swap fee (f_s) will have two components, a base fee (f_b) and a variable fee (f_v) that is a function of instantaneous price volatility. The fee rate will be applied to the swap amount in each liquidity bin and distributed proportionally to the liquidity providers in that bin following a distribution to the protocol. Fees will be held separate from liquidity and claimable by liquidity providers. The total fee for a swap crossing n bins can be calculated following Eq 4.8.

$$(4.8) \quad f_s = \sum_{k=0}^n \left[(\text{swap amount})_k * (f_b + f_v)_k \right]$$

4.3.1 Base Fee

The base fee rate (f_b) is a function of the bin step (s) and is scaled by a base fee factor (B), as shown in Eq 4.9. The base factor is defined at the creation of the pair and is bound between [0,1]. The base fee represents the minimum rate for all swaps and will range between 0% and the bin step parameter.

$$(4.9) \quad f_b = B \cdot s$$

4.3.2 Variable Fee

The variable fee (f_v) is designed to compensate liquidity providers for instantaneous volatility and incentivize liquidity providers to actively manage liquidity around a moving price. The variable fee is calculated per bin (k) using Eq 4.10.

$$(4.10) \quad f_v(k) = 0.5 (v_k \cdot s)^2$$

Instantaneous volatility is reflected in a newly introduced volatility accumulator variable, v_k .

4.3.3 Volatility Accumulator

Volatility can be derived from the number of bin changes over time. Each bin change represents a fixed price movement that is defined by the bin step. An accumulator is required to extend the application of bin crossovers as a measure of volatility beyond a single transaction. The volatility accumulator (v_k) is a function of the bin crossovers within a single transaction and its value in the prior transaction as shown in Eq 4.11.

$$(4.11) \quad v_k = \begin{cases} v_{priorTrn} + k & t < t_l \\ 0.5 v_{priorTrn} + k & t_l \leq t \leq t_u \\ k & t > t_u \end{cases}$$

The accumulator represents the number of bin changes that occurred over a variable set of prior transactions. When consecutive transactions occur between the upper and lower time constraints, the accumulator will decay by half (giving it a half life of 1 transaction). If the transaction frequency is greater than the frequency established by a lower time bound, the accumulator will not decay. If the frequency is lower than the frequency established by the upper time bound, the accumulator resets to a null value. To prevent excessive and persistent fees, the accumulator will have a maximum limit controlled by the pair contract.

4.3.4 Protocol Fees

The portion of swap fees retained for the protocol (f_p) will be controlled by a protocol fee parameter (ϕ). ϕ is a global parameter set by the team that will govern the fee distribution for all markets. After protocol fees are collected, the remainder will be sent to liquidity providers. ϕ may be set to any value in the range [0.1,0.25].

$$(4.12) \quad f_p = \phi \cdot f_s$$

5 DEX Improvements

5.1 Impermanent Loss

Variable fees provide liquidity providers compensation for managing impermanent loss under various trading dynamics. Given impermanent loss occurs due to price volatility, the volatility accumulator is a natural mechanism to adjust fees to market dynamics. Further, liquidity providers have opportunities to outperform this expected payoff due to the time decay of the volatility accumulator. This payoff is shown in Figure 6. Since the accumulator is based on bin steps, a tracking error occurs under extremely volatile events due to large deviations in nominal price changes.



Figure 6: Fee Adjusted Impermanent Loss/Gain

5.2 Liquidity Depth

Improving the capital efficiency of the exchange increases market depth for a given amount of capital. Capital efficiency can be defined as the reduction in capital required to provide liquidity equivalent to v1. For LB, comparable liquidity is found by equating the price impact from a swap on v1 to a single bin step. The efficiency equation resulting from that definition is shown below with efficiency limit results tabled in Figure 7. These limits represent the maximum efficiency for each market with a given bin step.

$$(5.1) \quad \varepsilon = \frac{-\sqrt{1+s}}{1-\sqrt{1+s}}$$

Bin Step	Basis Points	Efficiency	Bin Step	Basis Points	Efficiency
0.1	1000	21.5x	0.005	50	401.5x
0.05	500	41.5x	0.0025	25	801.5x
0.02	200	101.5x	0.001	10	2001.5x
0.01	100	201.5x	0.0005	5	4001.5x
0.0075	75	268.2x	0.0001	1	20001.5x

Figure 7: Capital Efficiency Limits

As seen in Figure 7, LB's efficiency is comparable to Uniswap v3 (v3). An evenly distributed LB position can be used to approximate a v3 position. If liquidity were to be distributed equally across bins in X tokens, then the relative difference in swap value between LB and v3 across the position is described by Eq 5.2. This equation can be plotted for a set of positions with various price ranges discretized into different bin steps, as is shown in Figure 8.

$$(5.2) \quad (v3 \text{ diff})_{x \text{ dist}} = \frac{1}{ns} \left(\frac{(1+s)^n - 1}{\sqrt{(1+s)^{n-1}}} \right)$$

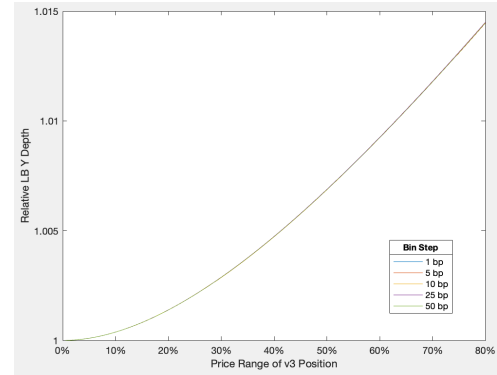


Figure 8: Market Depth Comparison to Uni v3

As evident in Figure 8, position price range is a substantially stronger factor for relative market depth than the bin structure. In fact, for a position spanning at least 2 bins the difference in depth across step selections is negligible. With the distribution specified above, the market depth of LB is within 1% of Uniswap v3 for any position that spans less than 60% price range. Moreover, the difference in depth is due almost entirely to the choice of liquidity distribution across the range (as compared to v3's geometric sequence) and is only significant over large range positions. These findings only further illustrate the value of the flexible liquidity distribution that is enabled by the LB protocol.

6 Conclusion

Liquidity Book (LB) is a novel design for structuring the liquidity of a decentralized exchange. It allows liquidity to be discretized into fixed price bins, improving slippage and swap pricing. Unlike prior concentrated liquidity protocols, LB avoids high impermanent loss to liquidity providers. LB liquidity structures allow for further composability and we are keen to explore new use cases with the DeFi community.

References

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