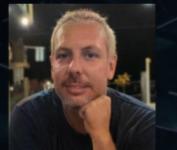# *diffusetap*
Virtual Event Series

How to (and Not to) Productize Staking

Guest Speakers:

Robert Ellison
Chief Growth Officer
Allnodes

Alison Mangiero
Executive Director
Proof of Stake Alliance

Hosts:

Kenny Estes
CEO & Founder
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COO & Co-Founder
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DiffuseTap: How to (and Not to) Productize Staking

Last time on DiffuseTap, **Robert Ellison, Chief Growth Officer at Allnodes, and Alison Mangiero, Executive Director of Proof of Stake Alliance**, talked to us about how crypto platforms mislabel their lending services as staking, why no two staking-as-a-service providers use the exact same model, and what the SEC gets wrong with staking.

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DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas)… straight from your armchair like a boss.

Meet the Speakers

ROBERT ELLISON has worked in protocol and network programming since the early days of web 2. Venturing into crypto in 2003, he later transitioned to cryptocurrency and joined two of the world's largest staking companies, <u>Figment</u> and <u>Allnodes</u>.

LinkedIn: <u>@bobellison</u>

ALISON MANGIERO is the Executive Director of <u>Proof of Stake Alliance</u> (POSA), a non-profit trade association. POSA advocates for clear and forward-thinking public policies that foster innovation in rapidly growing, sustainable, multi-billion dollar proof-of-stake ecosystems.

LinkedIn: <u>@amangiero</u>

About Diffuse

We are an alternative fund platform offering differentiated investment products. From digital assets, to VC funds, and beyond, we identify green field investment opportunities we feel will have market beating returns and turn them into professionally managed funds. For more information visit <u>www.diffusefunds.com</u>.

KENNY ESTES: We'll start with you, Robert. Would you mind telling the folks a little bit about your background and what you're up to?

ROBERT ELLISON: Sure. Hello, everyone. Going way back, my background is in protocol and network programming back in the web 2 days, when we were talking about using your browser HTTP and streaming networks.

I got involved in crypto very early on with zero knowledge systems back in 2003, when it was more around encryption and not cryptocurrency. And then, I followed that path to cryptocurrency in 2017, where I joined staking companies. I've worked at Figment and Allnodes, which are arguably two of the largest staking companies in the world that support proof-of-stake protocols. They basically run nodes and validators on the network. So, I've become a staking expert.

KENNY: All right, thank you Robert. And Alison, thank you again for making time in your hectic morning. Do you want to tell the good folks a little bit about what you're up to?

ALISON MANGIERO: Sure. As is often the case in this space, my background is completely different from Robert. I am a political scientist by training. The first 10 years of my career were spent in public policy, or what I would call traditional public policy. In 2018, I started working in the crypto space. I worked on the beta net launch of one of the first natively proof-of-stake chains, Tezos.

From there, I founded my own company and did some work helping facilitate the creation of open source software and public goods for the ecosystem. And then, I started running the Proof Of Stake Alliance, which is a trade association for proof of stakes, including big staking as-a-service providers and liquid staking protocols. We are also advocating for sensible regulation when it comes to staking. It's a nice blend of what I used to do in the public policy space and how I started out in the staking space.

AYLA KREMB: Awesome. I'll drop right in with the questions. Maybe we'll start off by getting an understanding of staking and how staking has evolved over the last six months. We've done a few sessions on staking so I think everybody's familiar with the overarching concept, but it has evolved quite a bit in the recent months. Robert, do you want to speak to that to make it more interesting yet again?

ROBERT: Sure. It's a battle to always make it interesting because we're talking about protocols, and we're talking about educating people to be interested in infrastructure, which is new. We've had a long history of being on the internet, and people have generally not cared about how things operate behind the scenes. But now, we're moving towards being tied to our digital lives more and more, and caring about what that means.

We have an incentive structure right now to invest in the protocols, or rather stake with them and get a reward. What does that mean? In the last six months, we're still fighting a battle of what staking means. I just came out of a breakout session here at Diffuse where the first question someone asked is why staking rewards are so unreasonably high.

The answer to that is because it's not staking. Across the industry, we still see people using the term staking. What they actually mean in a lot of cases is lending and providing liquidity, or all sorts of unique things behind the scenes. None of that is really staking. When you lend money, you're not staking. You're lending it.

So, what is staking? It's when you allocate your tokens to the actual protocol, like Ethereum. Then, Ethereum creates new blocks and you are rewarded, to keep it simple, out of the gas fees that are paid on the network as you secure the network. Those rewards come directly from the protocol right into your wallet. There is no middleman.

In terms of recent developments, and Allison can certainly jump in here, we saw the ruling against Kraken for what is considered pooled staking. And of course, in the regulatory landscape, we see Coinbase involved in the news as well, who are basically fighting the SEC and saying they're doing staking differently.

ALISON: Yeah. Just to echo what Robert said, I think around the time of the merge, there was a lot more attention that started to be paid to staking and what that actually means. I completely echo everything that you said. I think the term has been co-opted to meet a number of different things that it actually isn't.

Around the time of the merge, you start to see Gary Gensler saying "staking" or "lending" and using those things interchangeably, or saying that staking needs to be treated like any other interest bearing activity or account. I think part of the issue that we're seeing on the regulatory side is people trying to draw a straight line from a BlockFi to Celsius to what was going on in Kraken, and eventually Coinbase.

There is a lot more attention paid to staking now on the regulatory side. I think that's all the more reason why we have to be precise with our terms. That's why we're very focused on protecting protocol staking and that people understand that these blockchains actually don't function if a certain percentage of the network isn't staked. I think it's important to keep that in mind.

ROBERT: I could jump in there with something related to the question that popped in the chat. There's an easy way to determine if you are actually staking within a network. You're using your address in most cases, unless you are using a centralized address. At the end of the day, you have an address that you use to stake with and that address is used on the node to attest to blocks. That address could be looked up on a block explorer.

You can literally just take your address and throw it in. It doesn't really matter what network you're on. All proof-of-stake networks have these things called explorers. You could pop your address in there and you could see what's happening to it because at the end of the day, it's a public immutable ledger. That means no one can mess around with it. It's totally public and immutable. And that way, there's

transparency. That's one way you could tell if it's real staking. You could see your rewards being generated and the time of those rewards.

To answer the question about Kraken, we could go down the rabbit hole of what are the choices you make with staking. One of the first choices you make is how you custody them and hold your assets. Are you self-custodying them? That is, are you holding your keys at home and your wallet versus using a qualified custodian?

There are big NGOs that have those regulatory qualifications versus a centralized exchange or another party. That's actually not your keys. It's their keys. And so, you have to make that decision. All of those options allow you to stake, and they have different risk metrics.

In the Kraken case, for example, they were using what is called pooled staking. That is, they are using their keys and pooling the user base together. They were staking with that and they were being an intermediary, in the sense that the rewards weren't coming directly from the network to the end user. Allison, do you want to jump in there and expand on that?

ALISON: Yeah. I would say in terms of how the SEC sees staking or staking-as-a-service and Kraken, we sat down with the SEC in 2019 or 2020, when some of these first staking-as-a-service companies were founded and some of the first proof-of-stake blockchains were online. We wanted to make sure that staking-as-a-service providers were not viewed as offering investment contracts, and that they were viewed as offering the technology services that they're actually providing.

And so, at the time, we came out with some industry principles, which largely were shouted into the void. It was things like, "don't use terms like yields to describe a staking reward" because at the end of the day, if that's coming directly from the protocol, people are going to think of that as something fundamentally different if you use that kind of terminology.

Fast forward to Kraken, what Roberts said is exactly right in terms of what they were doing. But in the announcement surrounding the Kraken settlement, they said, "so therefore, all staking-as-a-service providers need to come in and register with the SEC." I think that is the stance they're taking. We're trying to do some education, saying "look, if it's done in a particular way, we think this is just simply providing a technology service."

If I choose not to stake myself and I engage Robert to stake for me, I'm doing that because I don't want to run the hardware and software involved, not because I myself would get a 5% yield, and he's going to get me a 25% yield, right? At the end of the day, I think what we're seeing from the SEC is they're saying that all staking-as-a-service providers need to come in and register. But we think not all staking-as-a-service providers are the same.

KENNY: You touched on this a little bit there, but I'm going to go a little bit deeper. I am no expert on the industry. But looking at it from the outside, it feels like staking is pretty commoditized.

Everybody is running the same code. You're validating transactions that are probably going to push down fees over time.

So, what is the actual state of the industry? Who are the major players? Are we seeing consolidation? How do you expect this to develop? Allison, since you're in the Proof Of Stake Alliance, maybe it would be good to start with you.

ALISON: Actually, I would be interested in what Robert would say first, because he's been working with some of the bigger players here, and then I can jump in. I do think we're seeing some consolidation, but maybe you can speak to what you're seeing in the market?

ROBERT: Yeah, interesting question. It's really hard to break this down analytically because of how cryptocurrency works. You could use Ethereum as an example, but that doesn't apply to other networks. It's quite a diverse mix. There are a lot of proof-of-stake networks out there. I don't mean to always talk about Ethereum, but it's the easiest one.

Consolidation is certainly happening if you look at some of the larger players. If you look now specifically, there's a huge queue to stake. It's a 40-day queue. There are 70,000 validators waiting to enter the marketplace. And a lot of that is a mixed bag because there is a considerable amount of retailers in staking. I would mention that there is a really great website called Rate.network that specifically works on Ethereum, and they just wrote a blog post to try to answer this question.

They saw that between around 6 to 8% of all Ethereum are what are called "solo stakers". That means they are home-staking or running it whichever way they want. That means 90% of current stakers are either centralized exchanges, which have a lot of retail customers, or entities that just have a lot of Ethereum.

It's a very diverse mix. You have companies like Ether Capital, they are a publicly traded company in Canada in which their shareholders hold and stake Eth. Their makeup is very different from a hedge fund that might just have a lot of Eth on their books. But we try to fight against too much consolidation. At the end of the day, we want this bedrock of allowing retail users, and allowing the bar of entry to be very low.

KENNY: Alison, do you want to expand on that? And also, it would be interesting to hear your take on what differentiates staking services from one another. Are they all homogenous? Are they all just providing a service and competing on fees? How do you actually differentiate the moat, or whatever you want to call it?

ALISON: We talked about solo stakers versus some of these staking-as-a-service providers, but I also think that things are getting even more interesting with liquid staking protocols now. That's because

while you have the large centralized exchanges and a lot of folks are choosing to stake there, not everyone who wants to stake has 32 ETH even if they want to do it on their own.

I think with the advent of liquid staking, you're seeing some more interesting things as opposed to people just choosing a staking-as-a-service provider based on their diligence of those providers and the way they're mitigating risks, etc. I think it depends on what your situation is in terms of what kind of staking-as-a-service provider you want to engage, or what kind of smart contract you might want to deposit your tokens into in order to be able to stake.

KENNY: Okay, a question from the audience. And we'll go back to you, Robert. It's about NFT staking.

ROBERT: Yeah, I saw it. I mean, it almost reverses what we originally said. There's that question and the one above it, and it's a really great point to bring up. Neither of those things are staking. Someone brought up stable coins, and you can't stake stable coins. You're lending them. NFT staking? Please. I've been in the business for three years. I don't know what that means because as far as I can tell you, you can't do that.

So, what are they actually doing? If they're saying NFT staking, you're probably lending your NFT out. You're probably lending whatever the value of that NFT is out to someone as collateral. Staking is a real mechanism. It is proof-of-stake for a reason. It means you're incentivized to add your tokens to an actual piece of hardware online that is attesting to the blockchain. So yeah, I'm not sure what that is.

AYLA: What about this question here about Eigen Layer. Have you heard of that?

ALISON: Oh boy, we have.

ROBERT: Yeah, we have. I have some interesting opinions there. Again, there are a lot of changes happening in Ethereum. Right now, we're working through those changes. The big immediate change that's happening, which I would advise everyone to pay some attention to if they're involved in this space, is called MeV. MeV is basically order routing. When you transact on Ethereum, like buying an NFT or sending your tokens to a friend for example, there is an order routing there.

It doesn't just get inserted into the block. There's a transactional routing, where there are all these participants bundling up transactions and then sending them to a validator to make sure they're correct. I don't want to go down the rabbit hole, but MeV is applicable to traditional finance, where if you have access to order routing, if you have low latency, you could skim and you could front run. Ethereum is solving for this. If you add Eigen Layer and liquid staking into that, it gets complicated.

MeV doesn't mean front running. <u>Front running</u> is just a capability within MeV. And just to mention what Eigen Layer is, it's not a layer. I'll say that. It's basically a smart contract that opens up staking to a marketplace. And in order for them to do that, they need your withdrawal key, which presents some usability problems.

It's a very interesting product because instead of building their own protocols, which is very expensive and time consuming, they're basically allowing participants to leverage Ethereum and specific slashing mechanisms that de-incentivize bad actors as a computational mechanism. Sorry to get technical there.

What that means is, imagine you have a new idea for a privacy protocol. You don't want to spend millions of dollars, and you just want to use Ethereum. You could go to Eigen Layer and use staking to secure your privacy protocol. It opens up a huge number of questions around risk metrics that I will avoid for now. It's very new.

ALISON: I would add that I think part of what we're seeing in terms of MeV is exactly what was said in the chat, that shorthand view of "Oh, MeV is just front running". When actually, what's going on there is very complicated. I'm not even going to try to explain it.

We're seeing that on the regulatory side, there was a piece of <u>legislation</u> introduced by Elizabeth Warren and Roger Marshall back in December which basically said validators and MeV searchers, amongst other folks, should be treated as money service businesses. There is a new version of that bill floating around, and it basically says they should all be viewed as financial institutions.

We're going to do a legal white paper on MeV in the market for block space, so I'm happy to share that when it's done. We're targeting a release in two months, and we're also going to be having a community call on restaging and Eigen Layer this Monday. The founders are going to be doing a presentation. So, if anybody's interested in that, I would be happy to invite you so that you can learn more.

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