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Virtual Event Series

What Happened to DeFi?

Guest Speaker:

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Head of Institutional Coverage
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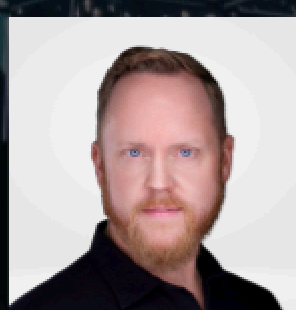
Hosts:



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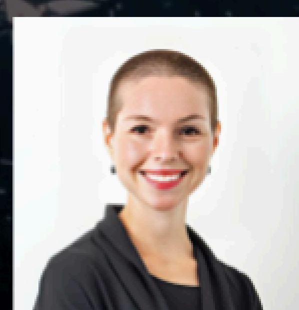

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DiffuseTap: What Happened to DeFi?

Last time on DiffuseTap, David Martin, Head of Institutional Coverage at FalconX, talked to us about the biggest downside to DeFi today, why restaking is changing the game for startups, and how we might see the altcoin market rally alongside growing institutional interest in Bitcoin.

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Meet the Speaker

DAVID MARTIN is the Head of Institutional Coverage at FalconX. With extensive experience in institutional finance, product management, and quantitative market analysis, Martin has a strong focus on disruptive technologies like blockchain and cryptocurrency. David is also recognized as a thought leader, frequently featured in top financial outlets such as WSJ, FT, Coindesk, and Forbes. LinkedIn: @mrtn-dvd

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KENNY ESTES: Mr. Martin, who is a repeat participant here, thank you so much for joining. Do you want to give the folks a little bit about your background and what you're up to over at FalconX?

DAVID MARTIN: Sure, happy to. And Kenny, I really appreciate you inviting me back. It's great to chat with everybody, and I'm really looking forward to today's discussion.

A brief background on me. I worked in traditional finance for a while. When I left in 2016, I was running a macro quantitative fund. I jumped into crypto somewhat early, from an institutional perspective, primarily focusing on running a hedge fund and doing high-frequency and statistical arbitrage.

That led me to look for institutional service providers that could support what I wanted to do in the space, and they were practically nonexistent because the industry was still growing. I was a client of FalconX, ended up joining, and my conversation with the CEO was simply, "I just want to build cool stuff that I wish I had as a hedge fund." That has been my approach since joining FalconX.

Our goal at FalconX is to provide institutional tools and services to help institutions through their journey into the crypto market. What does that mean today? First, it's aggregated liquidity, as liquidity is generally fractured—something we can discuss later on. Second, it's providing margin and credit. Third, it's treasury management and derivatives—ways for people to hedge risk.

FalconX is the only crypto-native CFTC swap dealer, so we're heavily focused on regulation as well as risk mandates. I'm really looking forward to talking to you all today, particularly about DeFi.

KENNY ESTES: Amazing. Let me jump right in. Super quick, high level: What is DeFi? I think most people in this room know it, but where are we right now? What is the status quo for DeFi? Who are the participants, and what problems is it solving?

DAVID MARTIN: DeFi is one of the most widely used products in crypto. The easiest way I like to explain it is this: If you think about how traditional financial markets are created, you have centralized entities—FalconX is one in the crypto world. In traditional finance, you think about firms like Goldman Sachs, a prime broker. DeFi is a way to distribute the underlying technology away from a centralized entity so you can do things like trading in a decentralized manner.

What does that actually mean? It's a complicated question, but simply put, in traditional finance, if I wanted to open an account at Goldman Sachs, I probably would not be able to. Goldman Sachs provides tools and services for certain types of institutions and clients who fit specific wealth profiles. In the DeFi space, you can just go and trade. You have access to trading and credit.

There are also other facets of DeFi—beyond just markets—like the gaming industry, which has boomed over the last year and a half. What we are seeing is decentralized ownership infrastructure, which spreads wealth around when products and services are successful in DeFi applications.

In simpler terms, you can think of crypto as building rails similar to TCP/IP—the underlying infrastructure of the internet. Most people do not understand how the internet works, but we all use applications on top of it. In this case, those applications are decentralized and often owned by the community in different ways.

KENNY ESTES: You mentioned the community, lending, and gaming. There are various flavors of DeFi out there. What are the downsides? Decentralization is great, but there is no centralized party—it's more of a technological party, in a sense. What are the downsides of DeFi versus traditional finance, or "TradFi," as we like to call it?

DAVID MARTIN: The number one concern we hear is, "Who do I call when something goes wrong?" Crypto is a volatile asset class that has experienced many ups and downs. In traditional finance, if something doesn't work, you can call your bank or Amazon, and someone is there to help. In decentralized finance, there is no clear owner, and you don't have that same level of support.

In institutional finance, this scares a lot of people. Consider the FTX bankruptcy—it was a centralized entity, but if that happened to a DeFi protocol, there would not be a clear court case or legal recourse. The downside of DeFi is that it's still early in the space. Some people really appreciate the anonymous and decentralized nature, but others—particularly institutions—want a hybrid between decentralized and centralized activities.

For institutions, centralization builds trust, while DeFi is a trustless system. That is a new concept, and it's hard for many people to wrap their heads around. Plus, when things go wrong, there is no obvious course of action, which remains a very open question.

KENNY ESTES: You mentioned FTX as a centralized party and how that can go terribly wrong. But DeFi rug pulls and corruption happen almost every week, if not more frequently, right? That ties into the point that you don't know who to go after, and even in court, only the most egregious cases seem to get addressed. Is that fair?

DAVID MARTIN: I'd say that's fair. While the number of scams in crypto has decreased since the 2016-2017 era, the issue persists. The challenge is that there is so much innovative technology being developed that I truly believe will impact everyone's daily life.

Most people do not need to understand how DeFi works under the hood, but it can enhance their daily lives—like making money transfers across borders easier. However, as Kenny mentioned, there are still scam artists trying to take advantage. It all goes back to doing due diligence before putting your capital at risk.

KENNY ESTES: That makes sense. You mentioned DeFi innovations—what is restaking, and how is it changing things?

DAVID MARTIN: Restaking is a fairly new topic and really started gaining momentum with Eigenlayer, which launched earlier this year. As an example, Eigenlayer—last time I checked, and the numbers might be a little off—had about $15 to $16 billion locked in their protocol.

What's interesting about Eigenlayer is that, historically, when a DeFi project launches, it needs to create its own token, which also needs to be supported. The whole nature of DeFi is that it's decentralized. If I'm starting a project, that is not decentralized. I'm the one who owns the tokens and validates all the transactions. To truly decentralize it, I need a global user base, and I attract those users with incentives, usually some form of reward or token. Essentially, I do X, and I get paid Y.

Overall, DeFi activity is a fraction of what it once was, and restaking has been a major narrative in the market over the past nine to ten months. It allows people to tap into large, decentralized blockchains that already exist, primarily Ethereum or Solana.

Instead of building their own networks and validators, startups can leverage the safety and security of these established networks. This is a fundamental shift within the crypto world. Restaking allows companies to use these existing decentralized networks rather than having to build their own from scratch, which helps avoid centralization and creates a trustless system more easily.

For example, the fact that Eigenlayer has secured $17 billion in less than a year is significant, especially considering that the total value locked in DeFi contracts has dropped substantially since its peak before the FTX collapse. The crypto ecosystem still needs to rebuild trust. Eigenlayer is trying to address that trust issue.

In a trustless system, it can be hard for many to grasp the concept and feel comfortable, but Eigenlayer solves this by leveraging Ethereum—one of the largest decentralized networks in the world—and providing a secure, reliable foundation. This allows entrepreneurs and companies to focus on innovating and building their applications, instead of having to develop an entire decentralized network that people will trust, in addition to running their business.

KENNY: You touched a little bit on the problems that restaking is trying to solve. What actually is restaking? So, like, if I'm going to go restake something, what do I do? And how does that allow for the solutions you were talking about there?

DAVID: Sure. Yeah, so restaking in itself—again, we will use Eigenlayer as an example—essentially, in order to use the service, what are you doing? You are committing assets, in the form of dollars, like a stablecoin or Ethereum, to a set of validators that are already in existence within the crypto ecosystem today and that have partnered with Eigenlayer to help build out their ecosystem and trust.

The actual function of doing it is going onto the Eigenlayer website, where I am committing capital in what is called staking, which is essentially locking it up for a period of time—I think it's seven days. That capital is now used to secure and validate transactions on these other networks that are being built on top of Ethereum, for example. For that, I get paid in reward points or tokens for having my assets on the network in the proof-of-stake concept. That concept is essentially the framework for the validation that makes the network secure.

KENNY: Okay, that makes sense. I'm going to try to pick up Chris's question from the chat and reframe it a little bit. Since 2020, I'd argue DeFi volumes are down pretty significantly, with the exception of something like Eigenlayer, which is great. Is that accurate? Is it way down? And also, what are some of the success stories in DeFi, in your opinion?

DAVID: Yeah, let's talk about TVL (Total Value Locked) real quick, because I think it's really important to highlight where it's at today versus where it was.

TVL refers to the dollar amount of assets locked in different crypto protocols across various chains, like Ethereum or Solana. The peak before the FTX collapse was about $150 billion—a pretty big number. The low point after FTX collapsed was around $35 billion, and today, TVL is sitting at about $65-70 billion. So it has climbed back to about half of where it was.

But one of the most interesting things I focus on is adoption. There is the function of putting assets on this network to get some kind of reward, and then there's the function of actually using the products and services offered in the DeFi ecosystem—much of which is done through trading.

To give you an idea of trading volume, it was averaging about $10 billion a day at the peak before FTX collapsed. It dropped to $1 billion after the collapse, and today, it's around $2 billion a day. $2 billion is still significant, but it's down 80% from its peak.

KENNY: That's a pretty significant drop-off. Let's switch topics a bit. High level, what's going on in the crypto market? I've heard a lot of buzz about ETFs. You're on the institutional side at FalconX. How is that impacting things? How are people changing their views?

DAVID: Yeah, so the market today. What I would say is, before the FTX collapse, and I use that as a cornerstone turning point because it made people rethink a lot of what they were doing in the crypto ecosystem—there was a heavy focus on altcoins.

Altcoins are smaller projects with smaller market caps. In TradFi, you would compare this to small-cap stocks versus large-cap stocks. In this case, large-cap tokens are Bitcoin and Ethereum. Obviously, the smaller-cap tokens are higher risk, higher reward, just like in traditional finance when you invest in smaller companies.

Pre-FTX, institutional investors and retail traders alike were focusing on these smaller projects and products. What's interesting today is that usually every rally in the crypto ecosystem is led by Bitcoin, followed by different technological functions being iterated on and launched.

For example, the first major token that gained lasting support was XRP and Ethereum, which changed the shape of what crypto could do. Then we had the ICO boom in 2017, which launched a lot of new projects, some of which were worthless, but others, like DeFi, emerged from that period.

We had what people call "DeFi summer" in 2020-2021, which led to the NFT craze. Now, we're kind of stepping back. Today, the rally we're seeing is primarily Bitcoin-led. Crypto is up this year, but not without volatility.

The biggest difference between today's market and previous markets is that now we have ETFs. Institutions are entering the market, but most institutional investors or high-net-worth individuals working with private wealth firms are primarily just trying to understand crypto, so they are investing in Bitcoin.

What does that mean? From a performance perspective, it's a Bitcoin-led rally, but most people in crypto assume that after Bitcoin, we will see an "altcoin explosion" with significant upside. That has not materialized this year, though.

Going back to your original question—macro, where are we? Crypto is a macro asset today. Many view it as a store of value, an alternative to gold, and I believe that's true over the next 20 years. But for now, people see it as a high-beta opportunity, a way to take or hedge risk.

I think that narrative will continue through the rest of the year. In the U.S., a lot of this also hinges on the political landscape. Crypto is on the political stage for the first time, and both sides have differing views. So, a lot is hinging on that, but there is also a lot of excitement because crypto is being talked about at a higher level than ever before.

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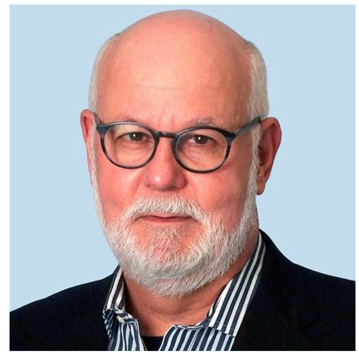

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