

CHAPTER NINE

DeFi

CRYPTO CONSENSUS VIEW

DeFi is an early success story for crypto with exciting long-term potential.

UNBOUNDED CAPITAL VIEW

DeFi has little long-term potential for success as currently conceived. Bitcoin's transparency and efficiency will improve financial services, not trustlessness.

As we described in Chapter 2, blockchain has seen very limited usage to this point. Even with hundreds of billions of dollars raised and over a trillion dollars worth of crypto in existence, actual usage of blockchain-based applications is miniscule. One mild exception is the area of DeFi, a shorthand for decentralized finance. In a February 2020 Coindesk article titled [Why DeFi's Billion Dollar Milestone Matters](#), writer Brady Dale wrote that "It was only December when the entire decentralized finance (DeFi) market was worth less than \$700 million. Early this morning, it hit \$1 billion, a figure that even the most fervent blockchain skeptics would have a tough time dismissing as meaningless."

That number has increased to \$140 billion at the time of this updated writing in April 2022, and this level of activity still dwarfs all other blockchain apps. What is the opportunity

seen in DeFi? In their [Mega Crypto Theses](#), Multicoin Capital describes the opportunity for Open Finance, their preferred terminology for the sector.

By making units of value—stocks, bonds, real estate, currencies, etc.—interoperable, programmable, and composable on open ledgers, capital markets will become more accessible and efficient. Just as the proliferation of capital markets over the last 100 years enabled staggering levels of wealth creation, open finance will make capital markets more efficient and accessible to everyone on the planet.

At Unbounded Capital, we fully agree with this thesis. However, we think that the current generation of DeFi protocols are doomed to fail for the same reasons as the protocols they are built on. The current generation of DeFi is happy to sacrifice efficiency to achieve greater trustlessness and censorship resistance. In our view, it is not these qualities, but rather transparency and efficiency that will improve the current array of financial services and create opportunities for new players who can effectively leverage scalable blockchains such as BSV.

Since our initial publication of this book, the size and scope of the DeFi markets have grown exponentially. Because underlying blockchains continue to support DeFi, the prioritization of decentralization and censorship resistance over scale and efficiency still resonate.

DeFi MAXIMIZES FOR TRUSTLESSNESS

Multicoin Capital makes it clear in their Mega Crypto Theses that they believe the success of open finance will be rooted in trust-minimization.

We cannot overstate the magnitude of this breakthrough. For the first time, financial markets can be global, permissionless, and for many kinds of derivative contracts, free of counterparty risk. This was impossible until recently.

The world's financial market infrastructure will move to the Open Finance stack because the Open Finance stack enables millions of businesses—those that are local, national, and international in scale—to offer trust-minimized financial products to the people and businesses who need them most.

As we established in Chapter 3, trust-minimization is not actually the removal of counterparties or trust. Rather, it is the substitution of traditional businesses for autonomous code as a counterparty. A brief look at the history of DeFi reveals these counterparties to be far from trustless.

Consider MakerDAO as an interesting example. MakerDAO is a multi-faceted platform. It allows crypto asset holders on Ethereum to lock collateral, typically ETH, to produce a stablecoin called Dai. That collateral is managed algorithmically to keep Dai pegged at one dollar. Governance of the system is done by holders of a separate token, MKR. MakerDAO is the leading DeFi protocol. More than half of all collateral locked in DeFi is locked into MakerDAO. As of May 2020, there was \$457M of collateral creating \$98M worth of Dai governed by \$350M worth of MKR. Andreessen Horowitz, a VC firm which had recently raised a \$515M crypto fund, was an investor in MKR.

MakerDAO is often compared to Tether, the leading stablecoin in the Crypto space with over \$8B in supply with daily volume occasionally exceeding \$100B. Tether is operated by Bitfinex, a major cryptocurrency exchange. Tether is often criticized for being centralized. Bitfinex has had legal issues with New York State. **According to Tether's own lawyer, at one point Tether was only 74% backed by cash or equivalents**, and again in October 2021, Tether's management companies were ordered to pay a penalty of \$41M for making misleading statements and omissions of material fact regarding their backing of USDT with other valuable assets.

In their piece **An Overview of Stablecoins**, Multicoins Capital describes the functioning and potential issues of a centralized stablecoin like Tether.

The first [method of issuing stablecoins] is to issue IOUs. This is the model used by tokens like Tether and Digix. Here, a centralized company holds assets in a bank account or vault and issues tokens that represent a claim on the underlying assets. The digital token has value because it represents a claim on another asset with some defined value. The problem with this approach is that it is centralized. These tokens require trust in the issuing party – that they actually own the assets being represented and that they are willing to honor the IOUs. This model imposes serious counterparty risk on holders of the token. Tether is the canonical example given the serious concerns that the public has about their solvency and legitimacy.

We agree that the solvency and legitimacy of Tether is a serious concern. What is interesting is that a community that values decentralization, trustlessness, and censorship resistance so regularly opts to use a centralized stablecoin. If the existing crypto community does not value decentralization in practice, it is strange that they tend to be so bullish on the ultimate success of decentralization. The reality is that traders greatly prefer using tether. Tether has held its peg much more effectively than has Dai. Even with as untrustworthy a counterparty as Bitfinex, Tether's founders incentive to keep Tether

backed is enough to assure Tether users. If a more reliable counterparty took on this role, it appears likely that they would dominate over decentralized models.

This concern that crypto traders have with MakerDAO may be well-founded. In fact, Coindesk reported on April 14th that MakerDAO is currently being sued by its users in a class action lawsuit.

The suit alleges the Maker Foundation and associated parties – including the Maker Ecosystem Growth Foundation, the Dai Foundation and the Maker Foundation – “intentionally misrepresented the risks associated with CDP ownership” resulting in the loss of \$8.325 million in investors’ money on Black Thursday.

Recently, on March 30, 2022, a gaming exchange called Ronin Network was subjected to the biggest cryptocurrency theft of all time, involving assets worth \$614M dollars. The attacker had stolen the private keys required to authenticate transactions and had transferred large amounts of Ethereum and a USD stablecoin to their own wallets. The company behind the Ronin network’s operations is now working with law enforcement to recover the funds.

Another example of a famous attack was the theft of \$611m from Poly Network in August 2021. Poly Network is a smart contract platform that allows users to exchange tokens between disparate blockchains such as Bitcoin and Ethereum. The attack was fundamental in that the attacker had found a way to buy tokens on the Poly Network protocol without selling the corresponding tokens on other blockchains. In a stroke of extreme fortune, the money was returned and disaster was avoided.

These two examples demonstrate how the code underlying the bridges that connect multiple blockchains could be vulnerable. It is no surprise that when attacks like this take place, the platforms responsible for recovering the losses due to the attacks rely on law enforcement to recover their assets. By now, it should be obvious to DeFi investors that code is not a risk-free counterparty. Further, the possibility that stolen or misplaced funds cannot be retrieved will be a non-starter for institutions.

Even more shockingly, in May 2022, TerraLabs’ “algorithmic stable coin” gave us a great example of the high risk of allegedly risk-free assets in DeFi. A stablecoin pegged 1:1 with the US dollar is as risk-free an example as one might expect. Despite the best intentions of its algorithmic self-balancing mechanism, the UST stablecoin broke its peg and rapidly lost 90% of its value, wiping out nearly \$19B worth of value in a matter of days. UST’s

more speculative pair asset LUNA fared even worse, losing nearly \$28B over the course of several days as confidence was completely lost in the ‘stablecoin’.

DeFi SUCCESS IS A FALSE POSITIVE

DeFi is an extension of the true current crypto success story, trading. Speculators have had a field day in cryptocurrencies. The largest businesses by far are crypto exchanges. Unbounded Capital has no problem with speculation, but it is important to recognize that this speculation may be a temporary state. If one network emerges from the pack as the dominant blockchain, how much intra-crypto asset trading will be necessary? In our view, large exchanges have been complicit in propagating a narrative that crypto is unscalable and that tradeoffs are necessary. This is great for their business, since a world with hundreds of protocols and tokens is much better for these exchanges than a world built on Bitcoin.

DeFi today is an extension of this trading-dominated reality. Crypto asset holders have very little that they can do with their assets. While they hold these assets, platforms that allow them to earn interest or gain leverage are very useful. Many traders are happy to get better rates by accepting greater risk through assuming autonomous code as a counterparty instead of traditional counterparties. Many services are also not offered by traditional counterparties for certain crypto-assets, making DeFi necessary in these cases. What this means is that growing DeFi usage today is not necessarily a trend that should be expected to continue.

HOW BITCOIN IMPACTS FINANCE

A consistent message from Multicoin Capital and similar investors is a desire to use blockchain to help bank the unbanked and increase access to financial services around the world. We share this goal. However, we think that the key to increasing access is to increase efficiency and transparency. The lack of access to these services for much of the world is much more likely an issue of costs and benefits and not an issue of trust or censorship. We believe that Bitcoin’s efficiencies will reduce these costs and make providing services to more of the world economically feasible. We also think that the centralization of information on Bitcoin will make coordination by financial institutions far easier

and that this will expand the reach of existing services and make new products and services possible. Increased transparency will help make the financial world more reliable. Replacing businesses with autonomous code will not.

As an example of a business increasing transparency, DXSapp (formerly TDXP) is a platform for leveraged derivatives trading that uses BSV's highly efficient immutable ledger to settle trades virtually instantly with fees as small as a fraction of a penny on the Bitcoin ledger. On DXSapp, anyone with some Bitcoin can enter into trades on stocks, crypto, commodities, forex, or stock indices with margin in trades sized as small as \$0.01. Active traders looking to enter and exit positions quickly can benefit from near instant settlement on the Bitcoin blockchain, removing the need to wait for T+2 settlement on legacy platforms.

The speed, efficiency, and flexibility of using DXSapp offers traders used to legacy platforms a substantial UX improvement, but for traders in emerging markets these advantages could be the difference between having exposure to these investments and being priced out. As a result, DXSapp has been focused on these underserved markets where the ability to access once impossibly-small trade sizes and low fees make all the difference. DXSapp has had significant traction in Nigeria, where internet technology is widely accessible but access to financial instruments holds significant friction.

Speaking of increased transparency in financial services, another focus of DXSapp is auditability. This is emphasized through its revolutionary liquidity engine which pools funds for its insurance pool from liquidity providers, offering them a stake in "the house" in return. DXSapp users who love the UX of the platform and anticipate its growth in the future can provide liquidity for DXSapp to pay out winners in periods where winners outpace losers, something that in the long-run does not persist on these platforms. In exchange for their provisions to the liquidity pool, users are paid out a portion of trading losses, a major revenue source for platforms like DXSapp. As with the simple placement of trades on the platform, all of this is easily accessible through DXSapp's web app or mobile experience and publicly auditable on the Bitcoin blockchain, which gives liquidity even greater transparency in the process.