FINTECH ONE-ON-ONE PODCAST 396-LAWRENCE WINTERMEYER

Welcome to the Fintech One-on-One podcast, Episode No.396. This is your host, Peter Renton, Chairman & Co-Founder of Fintech Nexus.

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Before we get started, I want to talk about our flagship event, Fintech Nexus USA, happening in New York City on May 10th and 11th. The world of finance continues to change at a rapid pace, but we will be separating the wheat from the chaff covering only the most important topics for you over two action-packed days. More than 10,000 one-on-one meetings will take place and the biggest names in fintech will be on our keynote stage. You know, you need to be there so go ahead and register at fintechnexus.com and use the discount code "podcast" for 15% off.

Peter Renton: Today's episode was recorded at the MERGE Conference in London on October 17th & 18th. I interviewed Lawrence Wintermeyer, he is the Chair of GBBC Digital Finance, also the former Chair of Innovate Finance and a Founder of that organization. He is a legend in the fintech space in Europe and around the world these days and writes regularly about digital assets and in this particular episode we talk about Paving the Way for Web3 Legitimacy, that is the title of the session. Lawrence gets quite feisty here, it's really a call to action for everybody in the Web3 space. It really was a fascinating discussion, hope you enjoy the show.

Please join me in welcoming Lawrence Wintermeyer! (applause)

Lawrence Wintermeyer: You’re too kind, my goodness.

Peter: How are you, sir, good to see you, good to see you. So, I gave you a little intro there, why don’t you just tell the audience a little bit of what you've been up to recently.

Lawrence: I'm dizzy from travel and advocacy work in Washington and Brussels, but I Chair a not-for-profit members organization that focuses on standards for the crypto and digital assets sector globally, that's where I spend most of my time. I do have a private business, I'm an Asset Manager, but, you know, for the most part I spend time in the advocacy space.

Peter: Right, right, let’s get right into it. This is all about Paving the Way for Web3 Legitimacy and one of the things that you've written about which I've really appreciated is the fact that, you know, what people complain about the fact that regulation hasn't really kicked in for this yet. You say, well a lot of the participants are regulated so maybe you can tell us a little about, particularly with Decentralized Finance, we’re not, it's not really talking about mom & pop investors, it's talking about, you know, institutions, right?

Lawrence: Well, I think rather than institutions, it's not retail clients.....

Peter: Right.

Lawrence: .....particularly in DeFi and there are a lot of different players in it, but certainly there are a lot of, you know, token, all those high net worth people, but there are a lot of asset managers moving into the space. And I think that that, you know, particularly sets the context for the direction of travel for digital assets full stop. It gives us a bit to think about, but I think, you know, if you would allow me, Peter, I think we should put our conversation into, you know, context.

You know, sitting here today, I think this is probably the most volatile macro situation, you know, a global economy that any of us will face and there are a number of reasons for that. You know, one, we can talk about global conflict which I think has a particular impact on government money printing and, you know, some of the fundamentals issues we're faced with, you know, at the same time we've got all of this volatility, we've got an emergence of great innovation. But that is often in highly regulated industries where regulators, frankly, only have very blunt instruments to be able to support that and that really topped off with a era where, you know, broadly cyber crime, and the resilience of, whatever it is we go into Web3 I think is in question.

So, you know, I think as we go through this chat we should try to unpick some of those macro trends that we see because I think that, you know, in the context of this market we're in it's probably the most difficult market since, you know, I would say possibly having listened to my grandfather talk about the era of 1929 to 1939 for all sorts of reasons. I don't think people necessarily appreciate it, we get a bit numbed by all of these global events going on and I think if you're in a digital innovation space, you are at war full stop. You are at war right now for a number of reasons, not least of which putting aside the dry powder on the sidelines in the venture of the private equity space, inflation and the cost of money is likely to kill you. If that doesn't, if you're in the retail space and you're in the Western world, your clients, whoever they are, are likely to have their mortgage rates doubled in the next year or so.

If you're not in the UK where there's a cap on energy costs, you're likely going to be unable to afford a lot of energy, So, some of the things going on in the market right now actually pale in comparison to, you know, regulators, policy makers and some of the blunt plan instruments in place. But, I think, more importantly, innovators are at war because they're being attacked from all sorts of different sides of the, you know, castle right now so we need to pay attention to that. So in DeFi, DeFi, for the most part, is being attacked right now, but has been, by the industry's own accord, predominantly a non-retail vehicle.

Peter: Right. So, let's talk about that. I want to reference the report you guys produced over the summer which was really excellent reading. In that, you kind of gave the industry a little bit of a call to action that we really need to be managing ourselves or the DeFi space should be really focused on self-regulation so tell us a little bit about, you know, what your thinking was there.

Lawrence: Well, again, mainly in that the evidence from the industry itself was that it's in a non-retail market, most wholesale markets are, you know, fairly regulated so if you accept that and if you accept collateralized lending, some of the more popular products that are in place where there's an absence of standard or regulation, you should adopt what we have. So, we have standards for KYC, AML, we've got wholesale standards for margin lending and you know, dealing with margin lending, we have standards for algorithmic finance, and particularly HFT and principles out of IOSCO, I mean, the list goes on. And so, I think it would be, you know, pretty important for most of us in industry as we've done in GDF to think about demonstrating to policy makers and regulators and highly regulated markets, which most of the markets we're in are highly regulated, that we can come together and certainly abide by standards. I don't think any regulator or anyone in the world believes in self-regulatory models, I mean, we do have our SROs around the world, but that is not an ultimate solution. It may very well be a destination on the way to what we would rather see as a Co-Reg model which we can get into.

But the important thing, I think, of the report was for the industry to really pay attention and start demonstrating that you're adopting standards that people in wholesale markets or incumbents do now while engaging regulators, particularly in innovation. And the importance in this instance of DeFi or DAO's is really how we get regulators on chain, you know, how we get government's nodes up and running and how we get them transparently engaging in blockchain or DeFi ecosystems because they are, to a certain extent, they are in the Stone Age and use blunt enforcement tools mainly because they don't really have very many other tools to keep up with this frightening pace of innovation.

Peter: Right. That's a challenge in and of itself obviously for them to be keeping up. Let's dig into a little bit, you just touched on it, this Co-Regulatory strategy, what do you mean there exactly, like Co-Regulatory with....obviously, you've got regulators that are implementing the rules, but what do you mean exactly by Co-Regulatory?

Lawrence: Well, in its simplest form, industry particularly, and again blockchain and the nature of governance, shared governance, really offers an opportunity for better partnerships with government and private industry. You know, we can convene on protocols to do that and I would certainly argue that private industry is better positioned to fund government exploration in this area, particularly in innovation. If you're waiting around for governments to fund innovation and digital innovation you'll be waiting a long time.

So, the idea of a Co-Reg model is really a safe space for industry and regulators to convene and, you know, particularly for them to at least go through a mutual discovery process of identifying material risks in any digital ecosystem. Before, regulators have to go back to policymakers and do what they need to do to determine whether they move down, you know, a rule-base, a principle-base approach with things. So, I think that collaboration, that upfront collaboration on risk identification is what we've been trying to move towards in GDF with our own reg forum for a few years.

And, again, regulators, I'm a bit empathetic, regulators are very open to this, but typically the gap in the digital crypto or digital assets space is at a policy level and it's been highly politicized for a number of years for all sorts of reasons for which often the industry doesn't do itself many favors. So, if you extend the mutual collaboration and risk identification and move a bit further down the line, Co-Reg, particularly for us in the context of a DeFi model, would have regulators and REG Notes or REG DAO online as part of consensus mechanism so that regulators can do what they should be doing in free markets which is sitting back and regulating and not trying to design products or put prohibitions in the design process that are over complicated.

You know you can understand, to a certain extent, why regulators in this era are in a space of enforcement because really they don't have very many tools and don't have very many opportunities to do things. I think with the exception of the sort of great work that Chris Woolard and his team did here a few years ago in launching the regulatory sandbox, most regulators aren't innovators. I mean, they might have an innovation hub, but there isn't anything innovative about it, they've either got a legal mandate or a charter that's focused on enforcement so, at best, they can do discovery.

Peter: Right. So, how then do you give the regulators the tools because you're talking about Decentralized Finance that might not really have a geographic location that is in the jurisdiction of the regulator because it's by its very nature decentralized, how do you think about that, what entity can be regulated in a decentralized world?

Lawrence: Well, you raise a really good point. So, you know, even in the context of the latest CFDC action against BZOX and, you know, B2X and Ooki DAO, the issue with DeFi for most regulators, as we sit here right now, is that it looks like an unlimited mutual liability structure. And so, I don't think that the industry is going to be able to go on much longer without looking at legal wrappers for DAO's, and so whether it's Singapore, Australia Treasury, murmurings of Germany, there are always things going on in certain states in the US, the states that'll be familiar to you, but this was part and part of the parcel of the situation we're in.

Where I think most regulators would say, you know, to the DeFi community, who we've regularly worked with, with regulators, you know, whether or not you look like a common enterprise that's raising capital and how you fund projects, if we put that aside, your government structure certainly looks like it is an unlimited liability network structure which would require a legal wrapper in most places because ultimately you're putting individuals in this case, as well as the collective mutual at risk, when things go wrong which is exactly what we saw with, you know, Mango Markets last week.

You know, again, this is something for us in the industry to pay attention to because that level of legal wrapper is going to be pretty important I would say, going forward in the future to operate a DeFi structure. And, again, you know, I think we're at a point within the industry to really pay attention to things and say, well, look, you know, if you want to create great products or whatever Steve Jobs' term was, it was called a gobsmacking product, outstanding products, you better get the design features of these. We need to start thinking about the social utility of the design features, right, because nothing is going to scale outside of a legal structure, particularly in highly regulated markets.

Peter: Yeah, that's very true. We're going to be talking about design and user experience throughout this event, but I wanted to touch on some of the gnarly issues here, I mean, what this can mean for users, like protocols, regulators, or what are some of the issues that you think are top of mind that most need to be addressed?

Lawrence: Well, I think we've just spoken about legal identity and the degree of legal certainty and liability is hugely important in any market for when things go wrong. I'll remind everyone now we've got the worst year for US government debt I think in history, we've got the worst year in the last hundred years. There have only been five markets where we've had the S&P, you know, bonds both down and I mean, they're both down so significantly, this is a huge impact of things. And, you know, again, people in the DeFi community are always saying, so why are you talking about this, well, this is pretty, pretty important. I mean, this is our macro economic circumstances that we're speaking about which impact a number of things, particularly they impact not just the capital that's available to you, but the way that priorities and policy makers, or regulators, are going to look at things.

You know, and at the same time, we have a community which I would say has been openly and our own community has been openly working with regulators on every aspect of DeFi, the construction of DeFi and what it is that we need to do to address the material concerns of policy makers and regulators to make the pool safe for everyone in the future and make it scalable in Web3. And so, you know, at a time while we're sitting here in the UK where the Treasurer has just lost his job last week, stability is the key word and despite the new chancellors U-turn on corporate taxes, there's still around 45 Billion of unfunded liabilities, you know, the markets and the free markets are speaking.

Peter: Right, right.

Lawrence: I mean, I think the Asian markets were marginally up on the pound, but, you know, it's at about a buck ten. And so, if you look at that instability, particularly from one government and, again, as a community, most of us have been, you know, focused on the FSB, listening to Janet Yellen and speaking about financial stability, the UK looks as if it's almost a failed state in the context of the G7 nation right now and really needs to, you know, fix itself.

So, I think you need to put those macro trends into the context of where we are with things because we're only in a more volatile space and, you know, the context of priority, particularly government policy and priority as it relates to crypto or digital assets, I think is probably going to move pretty far down the line, I would say. So, I think that's a great opportunity certainly for funded projects to come out and start to demonstrate they can behave in a way that is scalable as we start to build the infrastructure on Web3, I would look at that opportunistically.

Peter: Right, right. There's been a lot of blow-ups in DeFi. I was reading, there was a thing in CoinDesk last week that talked about, it was written on October 13 and was already the worst month in DeFi history for hacks and for things like that. The industry doesn't do itself any favors obviously by having all these kind of blow-ups, but how are we going to kind of address who is responsible because that's what the regulators want, the regulators want to say there's fraud, this person is responsible, this entity is responsible, let's go after them. How does that work in a DeFi world?

Lawrence: Well, this is again why identity, legal certainty and legal wrappers become important. And so, I started coding long before the worldwide web and the Internet even existed and, you know, I don't code now, the closest I've come to it is broadly quant asset management and other people do that, thankfully. Other people, you know, implement the technical code and the math that I could only dream of, but I think the importance to this question is you need to ask yourself in a common law world or in a civil law world where it is that you would be able to go and offer highly regulated products without some form of identity provenance and liability, mainly to protect yourself when things go wrong.

And, I think, you know, in a world, particularly where, you know, in innovation we're at war not with regulators or with policymakers arguably with the macro economy and the amount of capital that'll get dispensed, but we're at war through quite often cyber, and it isn't hacktivists, it's syndicated crime who actually move as quickly as innovation, fleeing and evading, and it's state-sponsored crime. You know, I think this is important for people to put into context,

Bloomberg estimates that government intervention or that broadly 26% of GDP by 2050 will be from the free market, inferring that 75% of global GDP will be not from democratically capitalist oriented countries. And so, I think people should really bear that mind because it's not just super quants that are in syndicated crime that are hacking you, the focus on state-sponsored hacking and the destruction that it's trying to do to capitalism makes things like Mango Markets if you're a cap markets or an institutional person look like quite a bit of a joke.

You know, broadly, the manipulation of a price oracle, you know, to inflate a collateralized asset position and allow the hacker to take out $100 Million which happened to be the liquidity of the market, I mean, you know, next to the chancellors' unfunded budget, it's a bit of a school boy error if you're a serious technologist and you're trying to develop really great products and stuff. So, I really do think that, you know, again this is something that the industry needs to pay attention to. I'm a pacifist, I don't like to sit in front of folks on a Monday morning and talk about being at war, but we need to really re-orient ourselves and be very aware of the digital and economic world that we're operating in.

Peter: Right.

Lawrence: This isn't just a bit of, let's push a bit of code out and fail fast and, you know, mess up the economy, you know, particularly where we have you know, significant products like wholesale financial or lending products, etc. And then you know as well as I do, it doesn't matter what statistics we quote on hacking, the US retail statistics said broadly 60% of people have indicated that they've been victims of some sort of cyber crime.

That leads you right back to identity and making sure that we get the provenance of an individual identity right in the infrastructure along with our cyber protections going into Web3. Otherwise, I just don't think any of this stuff is really going to scale, right, because if you look at all of the things that you know….do you think DeFi has right now….look at the hacks on Binance recently. I mean, the industry just does not look like a very safe place to put your money right now.

Peter: Right, right, okay. We've got quite a lot of questions coming in here, I think we'll take this one. You mentioned the idea of a REG DAO, how far away are we from effective and appropriate DeFi regulation?

Lawrence: I think we're far away from anything that's effective or appropriate because with the exception of MiCA in Europe which is a fairly European and comprehensive top down regulatory framework that's particularly focused on crypto and the tokens, E-money tokens, and Stablecoins and then asset referenced tokens and the spot market, we don't have anything about DeFi. And where we have functional regulatory equivalents right now in the world, I would argue is in the US and Europe, you know, broadly with Stablecoins and the crypto spot and cash derivative market, although the US is likely, you know, not wanting to do anything until we get through the election period, assuming the FDIC, or where we are with Stablecoins in the US is likely not going to happen till next year, so where does that leave DeFi?

I would certainly say from our perspective, there's a sovereign race now to get legal DeFi structures identified in order to crowd-in DeFi as, you know, I think that's a recognition that it's a very viable tool. We know that most folks in cap markets like it, but I would expect some sort of clarity on DeFi legal structures coming out of jurisdictions and that's probably as far as we'll go. I mean, my own view is that DeFi is a composable set of tools that, again, we have standards for in many other places as well. So, you know, it depends on how you want to compose DeFi, but certainly legal DAO structures I think are not too far around the corner.

Peter: Right, right. So, number one here, the similar type theme, is the solution to move away from open networks to DeFi on closed networks?

Lawrence: Well, I think with the exception of the blockchain which I love, which is a public network, which I think is the most secure and resilient thing in the world until Quantum comes anyway, it's the bridges, the on and off ramps, and the Web2 infrastructure that is the weak link in the chain, but there is a greater focus certainly on permissioned, or closed networks for DeFi, you know, for a number of reasons. Mainly in, if you don't have the identity or provenance in the voting structure, you have no resilience. Well, one, you could spend, you know, a whole session talking about governance and voting structures in DeFi, but you need some degree of financial probity.

And, again, I do say this, I've been regulated in markets trading, you know, hedge and other products, you do need people to ultimately take accountability for even algorithms or the trading program that's going on, and they do need to know stuff about this. I mean, it's nice to think that, boy, you know, in a bull market people can trade and arbitrage things and make money, you know, over the long term, the maths are against you. So, one way or another, you need to have some sort of sense of control even over algorithms, and so I think in that context the move towards a more private, or consensus networks where node operators actually do take some sort of responsibility for the underlying liability of what's going on is certainly what we see in, you know, merging in the institutional space.

Peter: Right, right. So, we're almost out of time and I just want to end with, you know, what you kind of wrote about in your paper as well, this sort of call to action. We are at a pivotal moment, I know, we have a macro environment that's extremely unusual, that's something none of us have lived through, we're talking about Web3 legitimacy here. I mean, what sort of a….the one thing that you'd like to leave the audience with. Like given the context of where we are, what's the most kind of practical thing that we can do to create more legitimacy?

Lawrence: Private markets have more money than governments so I'm very focused on, you know, I have no idea what Web3 is. But whatever it is, if it's the next generation of the technologies that we're working with and, you know, Tim Berners-Lee hates that we've conflated blockchain with Web3, it just annoys him and then I have no idea what the Metaverse is and, you know, I'm not even sure Mark Zuckerberg does, but, you know, we can wait and see. I think from a practical perspective if you're a builder and you're a digital innovator it's really boring, but we need to get the infrastructure right.

And the infrastructure in this case has to do with identity provenance and cyber resilience, I mean, those are the two things that I think we need to bake into any infrastructure in order to be able to build successfully in the future. Again, otherwise, I don't think many of these digital things will scale to a point of social utility that make them good enough that, you know, meet Clay Christensen's disruption innovation theory of, you know, it does a job, and it has that sort of a utility.

Peter: Right, okay. We'll have to leave it there, Lawrence, thank you very much for coming and joining us today, appreciate your thoughts.

Lawrence: Thank you, Peter.

Peter: Okay, see you.

(applause)

(music)