Why We Can't Have Nice Things — A Cautionary Tale for the DeFi Space

Every market blows-up when the charlatans outnumber the developers or when the newly anointed "thought-leaders" are the charlatans. And this time is different usually isn't.

DeFi has entered the phase where wearing a t-shirt or hoodie emblazoned with "HODL", "DOGE", "$BTC" or "ETH" signals unimpeachable subject matter expertise. Even more worrying is when/as thought leaders brand themselves as (laser-eyed) maximimalists for the seeming purpose of trying to appear decades younger or to mask an absence of subject matter expertise.

DAOs, DEXs, Protocols, Oracles, Block structures, Wallets, AMMs are all wickedly complex. There have never been markets which have demanded more technical expertise. Crypto and digital money requires unique multi-disciplined risk management — ruinous drawdowns can result from any of: the wrong asset, the wrong storage, or the wrong trading venue. In securities markets, one is unlikely to lose everything by trading on the NYSE instead of the Nasdaq or by custodying assets at BNYM instead of State Street.

Further, regulation is coming. Not only in the US, but probably across every market and country that matters. Regulation is an inevitable consequence of scale and adoption. Regulation exists to protect the public from informational asymmetries and inadequate safety measures; pharmaceuticals, healthcare, aviation, and securities markets are all unthinkable without regulation.

Good regulation should help the more skilled and professional operators and frustrate the unskilled and reckless.

What's missing in the DeFi anti-regulation camp is that it's not Coinbase or Kraken that will "take the system down" (AIG Financial Products-style), but it's the worst in class operators and those with inadequate systems and controls that are likely to ruin markets for everyone.

The following is a brief list of markets which were destroyed or permanently damaged by less skilled, careless, and opportunistic entrants:

Mortgage-Backed Securities

the early days of mortgage-backed securities was a combination of the best programmers, mathematicians, and traders on Wall Street — think Bell Labs meets Michael Lewis's "Liars Poker"

the less skilled: Bear Stearns, pre-BAML Merrill

Securitization

the early days of securitization were the merging of MBS structuring and data techniques to create more complete capital markets — at its best, securitization allowed for the separation of assets from their originators, lowering risk to investors and improving financial operation for originators

the careless: Washington Mutual, Countrywide and others

Credit Derivatives

credit derivatives are essentially a contractually-based offshoot of securitization; move obligor risk without moving the assets — nobody told the late bold entrants that credit derivatives required legal, trading, credit, and operational expertise, and that one actually needed to read documents

the reckless: AIG Financial Products

Now is the time for the best in class operators to champion constructive regulation to protect everyone's interests — so we can have nice things.

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