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Re-engineering Tokenization | Episode 10
Walt Lukken, President & CEO, FIA

We close out our *Re-engineering Tokenization* series this week with Walt Lukken, President & CEO of the FIA and Former Acting Chairman of the U.S. Commodity Futures Trading Commission. David Greely sits down with Walt to discuss the state of the conversation on tokenization in the cleared derivatives industry – and what the next steps are towards bringing tokenized assets into the mainstream.

Walt Lukken (00s):

For me, it's an exciting time as I talk to people. It's anxiety ridden too because it's about change, right? I mean, people don't like change, but I look at it really high level. People are interested in our markets. There is demand for our markets and our products. We should be blessed and happy that that is the case and we just have to be resilient and move along with the change and it's going to be a big positive for our industry.

Announcer (26s):

Welcome to SmarterMarkets, a weekly podcast featuring the icons and entrepreneurs of technology, commodities, and finance ranting on the inadequacies of our systems and riffing on ideas for how to solve them. Together we examine the questions: are we facing a crisis of information or a crisis of trust, and will building Smarter Markets be the antidote?

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David Greely (01m 15s):

Welcome back to Re-engineering Tokenization on SmarterMarkets. I am Dave Greely, Chief Economist at Abaxx Technologies. Our guest today is Walt Lukken, President and Chief Executive Officer of the FIA and Former Acting Chairman of the US Commodity Futures Trading Commission. We will be discussing the state of the conversation on tokenization in the cleared derivatives industry and what are the next steps towards bringing tokenized assets into the mainstream. Hello Walt, welcome back to SmarterMarkets.

Walt Lukken (01m 47s):

Hey Dave, how are you?

David Greely (01m 49s):

I am doing okay. It's been a busy year, but it's good to have you here to wrap up our series on Re-Engineering Tokenization and in a way wrap up this year. I know you have been traveling quite a bit and you were recently in Singapore for the FIA's Asia Derivatives Conference. Coming off the back of that, how big a part of the conversation has tokenization been this year?

Walt Lukken (02m 13s):

Well, most recently it's become enormous. Part of our conversation. Even a couple weeks before Singapore, we had our Chicago conference where it was predominantly featured on our program. We had Jeremy Allaire from Circle speaking about stable coins and USDC and so people are fascinated by the, the possibility, the vision of what tokenization and stable coins can do to our markets to make them safer, more transparent. But there is some hurdles we got to get through first. And so while there's excitement, there are devils in the details and there's still some things to do, but it's definitely a prominent part of our discussions right now at FIA.

David Greely (02m 59s):

And I know as you said, there is opportunities and there's challenges. And what's the current state of the debate on the benefits of incorporating tokenized assets into the traditional derivatives industry?

Walt Lukken (03m 12s):

Well, I think the important thing is what is it solving for? And I think it's solving for the failings of the public payment system right now that are not open full-time. People can't move money on weekends. So it's important that we are, what is it we are trying to solve for? And I think tokenization and stable coins can offer an opportunity that people can move value at any time to custody those assets in their wallet and have transparency to what is going on with the payment rails. So to me that's very exciting for us as an industry. We have struggled when there's been long weekends where markets may be moving but you are not able to settle those trades and so that to us is the biggest promise of those assets is that we may be able to solve this longstanding issue where on holiday weekends or risk builds up over the weekend because of volatility in the markets, but you can't move money and so for us, this has great promise to try to solve for that and we're working with CCPs and others to try to figure out how to do it.

David Greely (04m 23s):

And it's interesting that he referred to some of the deficiencies in the payment system 'cause that's really outside of the derivatives industry itself, but just the ability to move cash 24x7, is that one of the biggest pieces you see?

Walt Lukken (04m 37s):

Yeah, and this dates back to when we had the Winklevoss twins in 2018. I can't remember the dates when they spoke and they said one of the driving factors that got them into Blockchain and to Bitcoin was the inability to move money 24x7 and they gave the example that it was easier for them to take a suitcase of cash and fly to Singapore and it was faster for them to do that than to wire the money and so they saw that as a differentiator for their product. And so I think that has slowly started to sink into the traditional finance markets that we deal with. It's to see how can we use stable coins and other assets to put them on tokens and be able to move them in real time and it's very exciting.

David Greely (05m 27s):

It is because as you said, you know mentioning buying a suitcase of cash to Singapore, it's not just a US market or a European market, it's a global market and so even the concept of 24x7, it's always business hours somewhere in the world. And so we, we need to be able to operate as a global industry. And I was curious, when you look at this and there has been a lot of other items on the FIA agenda for years that I think tokenization helps enable. So even things like faster settlement times and moving to T+ Zero, how do you see it helping some of these other challenges or projects that have been in the works for quite some time?

Walt Lukken (06m 08s):

Well, it's really building the foundations to solve for all those projects. And so if we can get this right, then you can start to move money faster, you can de-risk the system faster, getting to T Zero, getting money in the right account faster. So those are all things that we have been working on. But we didn't have the ability because of the public payment rails to achieve those and we had to do workarounds as a result of this. But this fundamentally changes the game. So if you can move value any time of the day to de-risk the system, we can start to think more broadly and also start to grow the industry. The ability to do that, if there is less risk in the system, it means that there is more capacity in the system to take on new trading. For us it's not just a helping to make sure the markets are safe and sound, that's incredibly important, but it also provides greater capacity for the industry to grow. And this is a great news story for us.

David Greely (07m 15s):

And this summer you released an FIA white paper titled Accelerating the velocity of collateral, the potential for Tokenization and Clear Derivatives Markets. And I wanted to ask you, why is improving the movement of collateral so important and what are the major benefits of tokenization for the movement of collateral?

Walt Lukken (07m 35s):

Our clearing system is based on the fundamental premise that clearing houses manage the counterparty risk of all its market participants. But that requires us to back trades by collateral. And we have been doing that for many, many years. That actually was one of the lessons of, of the financial crisis is our markets worked when others didn't and it was clearing that was at the central aspect of why our markets worked. So this is trying to improve that clearing system even more by allowing the de-risking real time of trades. So as trades happen, we can collect from customers quickly submit that to clearing houses and that just takes risk outta the system as it is happening. What we saw in the financial crisis was risk building up. No one knew where it was, they couldn't see it until catastrophic results occurred. So clearing allows us to be very transparent to move risk quickly and by modernizing through tokenization the back office systems, it's really gonna help us to do this even more in real time.

David Greely (08m 45s):

And have you heard any arguments for the risks this could pose to clearing if it's not implemented well?

Walt Lukken (08m 53s):

No, absolutely. And I don't want to overstate how close we are to implementing this. It still is a promise, not necessarily in practice and part of it is the word Stablecoin, how stable is it and so there have been points of time in the past where dollar Stablecoin was not worth a dollar and so how do we ensure that when you need cash, and that's really what in a default situation, if you are converting stable coins into cash or if the stable coin itself is the end cash unit, is it going to be stable? Is it going to be a dollar and right now dollars are the reserve currency of the world because they do retain value. They are the riskless collateral that the world utilizes. But will stable coins take their place and I think the Genius Act was passed in the United States. It has to be implemented to ensure that indeed there is dollar for dollar reserves that those reserves can be accessed quickly. There is accounting of those reserves by regulators and so that is super important to get implemented. And once we have that in place, people start to utilize this more, there is going to be more reliance on this. So we don't actually see this as a wholesale change happening very quickly, but something that starts to get implemented transitionally over time as people get more comfortable with it. I

David Greely (10m 28s):

Think many of us remember during the financial crisis when some money market funds broke the buck and none of us want to repeat that said you see stable coins as ultimately being back dollar for dollar.

Walt Lukken (10m 40s):

Well I think that is the requirement of the Genius Act is my understanding. It's so whether it's treasuries or dollar, whatever, but it's meant to have assets sitting behind it. Unlike dollars though, Stablecoins do have some counterparty risk to it. They are, they have an issuer and let's say something happens to one of these issuers or a reputational issue of fraud of the CEO or something, you could see people starting to, you know, exit in a bank run on that digital currency. And so we have to sort of solve for those things Again, how do we keep Stablecoin stable and there is probably ways these are solvable things and some of it's just going to be people utilizing the asset and getting comfortable with it. But we just have to be aware just like money market funds and we put in reforms after it broke the buck, the prime fund broke the buck financial crisis. And so we are trying to make sure that that does not occur for these types of new stable coins. And it seems to me that people are trying to solve for it.

David Greely (11m 44s):

Switching from the stable coin side to more of the collateral side, what assets do you think will be the first to have tokenized versions used for collateral at clearing houses?

Walt Lukken (11m 56s):

Well, money markets have been mentioned as one because of the fact that they are very stable, there are these reforms. And so I think right now for initial margin there is a variety of types of collateral you can hold. Oftentimes the that collateral including US treasuries are haircut cutted. So we discount for every, if you want a dollar of value in IM, you have to hold a dollar three of treasuries in order to cover that and so I think there are ways for us to use tokenized assets in small percentages with possible haircuts as we start to transition them as acceptable collateral for margining. So to me, deposits and money market funds are the likely ones that are most stable, most accepted and probably are the first in line to be tokenized.

David Greely (12m 51s):

And you brought up a really important topic which is the haircuts because often we began this conversation talking about 24x7 clearing, moving to shorter settlement times and that as well as convenience, it comes down to money because if you don't have to be shut for the weekend, if you don't have to be shut for the evening, you can have smaller haircuts applied to many of these assets. How big a focus is that for market participants?

Walt Lukken (13m 19s):

I think it is. I mean it's certainly one of the issues I think we've noted needs to get resolved. I think Jeff Sprecher, who I interviewed from the CEO of ICE, he said it doesn't make sense to me that treasuries are haircut cutted in a clearing house but stable coins that are backed by treasuries are not haircut, cutted. It's clearing house and so I do think there has to be an honest assessment and really haircutting should be based on data, it should be on stressed markets, events. How did that asset behave in stressed market events? Did it lose value, did it not? And so those are things that hopefully we can start to find a international standard around how much we

should haircut these instruments and try to get the right amount. Because ultimately we are trying to make sure that in a time of crisis as everybody is running for cash, that the cash is there, dollar for dollar, the cash is there and so we want to be conservative about this and so hopefully regulators take a bit of a conservative approach here and base it on data and I think over time we will get there.

David Greely (14m 30s):

And I am curious in your conversations, how much enthusiasm is there amongst clearing houses and their regulators to use tokenized assets as collateral?

Walt Lukken (14m 41s):

I think there's excitement. I think like anything, people are always hesitant to change if the current systems are working. So this is change and sometimes you go to push people along. I think our view is it's gonna be better for the market so it's going to be a conservative effort of regulators helping to push for this and to remove impediments. But ultimately it's the market that has to demand this and I think there is some demand here and I think CCPs are looking to experiment in this area. Like I see as we head into 2026, there is a lot of people we have surveyed. What do you think it's gonna happen in 2026 or beyond 2026? I think we will get some really healthy experimenting going on in 2026. I don't think we will be there totally. I think that's a closer to a three to five year period of time for us. But I think you will really start to get practical experiments happening among CCPs and as people get comfortable with it, I think you'll start to see more adoption among the industry.

David Greely (15m 50s):

And are, are there certain questions regulators have been raising or things they would like to see come out of these experiments to give them comfort?

Walt Lukken (15m 59s):

I think they are learning, like all of us are learning about this, I think part of their role is in the CFTC just in issued some guidance around this should there be acceptable collateral and so there are legal impediments that have to get clarified and resolved to make sure that you can start to accept these things as acceptable collateral on clearing houses. So regulatory agencies from the US, the CFTC and SEC, but you have MAS and Singapore that's been very forward thinking on this. They have Project Bloom, which is a, a project that they allow experimentation of industry people in a regulatory sandbox. So the rules can be exempted for certain activity. You have BIS, the bank of international settlements doing a project, project Agora on this UK is very active on this and so for me the regulators are learning. I think they seem open to understanding it and allowing some participation and small pilot projects. But I have not heard anybody say this is not a no go. I think there is some openness right now among the policy community because they see this as the future.

David Greely (17m 15s):

And I would like to dig a little deeper into the collateral issue. Clearinghouse there is the distinction between initial margin and variation margin with variation margin still largely requiring cash for the most part. While many more types of assets qualify for use as initial margin, what do you see as the challenge to bring tokenized assets for use in each form of margin?

Walt Lukken (17m 43s):

Yeah, I think IM initial margin is probably the first to, to accept and to utilize tokens. And again, because right now IM does accept various forms of collateral and each clearinghouse is different but they tend to say, you know, we are willing to accept cash treasuries but other types of assets that are discounted are hair cutted in order to accept it and at a smaller percentage and, and so I think there is room obviously in that type of diversified portfolio set to allow these new products to start to happen. I think variation margin is more difficult because as we talked about earlier, it's a pass through. So variation margin is just the losers paying the winners, the money from each day's market moves and so that has to be dollar for dollar cash right now and if you substitute in a representation of cash, then that gets a little trickier. Is it going to be a dollar for a dollar and do we want to do that or not and so I think that's a, again, down the road a bit more as this becomes more accepted tender as we head down, you know, three to five years from now that there may be more willingness to go to variation margin and using tokens but right now again, if it's not broken don't fix it and I think people are happy with cash and don't really necessarily see the advantages of moving to a tokenized asset at this point.

David Greely (19m 19s):

And how big of a challenge is it in that trying to bring change to an industry with global participants but with exchanges and clearing houses that are locally regulated? It would seem like you might have a bit of an all or nothing, right? If one jurisdiction approves it but

others don't, it could make it difficult in a global environment. How do you think about that maybe with your former acting chair of the CFTC hat on?

Walt Lukken (19m 49s):

Even our paper, we try to go to first principles of how this should look and what types of regulations should be a part of this project but I think international standard setting is important. So IOCO can be helpful in ensuring that the principles of how tokenized assets should move forward, they can help to set those principles and how regulators approach it. But I do think right now the markets are moving so fast, the CFTC has been very aggressive in providing guidance and encouraging the use of these tokenized assets. I think Europe and Asia have been a bit more cautious about it. But like anything in the world, competition drives change and so other regulators that see one regulator moving forward, they can either move forward with them or decide not to but that may come at a cost and so I think regulators there is, this is certainly not a race to the bottom because I think this is a blank piece of paper. I think regulators are trying to figure out what is the smart regulation, the right regulation of these products, but allowing these tokens to, I think the US moving into this space is likely to cause Europeans and Asians to move faster into this space and to try to sort of keep pace with allowing these assets going forward.

David Greely (21m 16s):

And is there any analog in your memory of the industry and the markets to bringing in a new product or a new way of doing things? The way tokenization could represent?

Walt Lukken (21m 29s):

You know, that's a really good question. I am trying to think through. I think in many ways electronic trading was one of those things where it just, once it happened, it happened insignificant. Everybody moved to electronic trading over a period of time and it ultimately led into the death of pit trading globally. I see where once this takes off, you are going to start to see great reforms among exchanges globally to try to keep pace. So I don't know if there is a one for one analogy here that I can remember, but to me that was, you know, the move from physical trading pits to electronic trading is probably the closest analogy I can think of.

David Greely (22m 14s):

And you have mentioned a couple of times in this conversation that this isn't something that's gonna happen overnight and I was curious how much work needs to be done on the legal and the regulatory side to bring these tokenized assets into the mainstream of the clear derivatives industry?

Walt Lukken (22m 32s):

Well I think one of the big things is just implementing the Genius Act that was just passed in the United States and other jurisdictions. I think Europe has MICA and making sure that the sort of fundamental base regulatory system is in place for stable coins and tokenized assets and so that will take a year to get into place and the prudential regulators have to get all those rules out for comment and that will be helpful because that's going to bring credibility to those products. I think the secondary thing will then be the market regulators will have to look at their rules and regulations. For example, there is a rule in the CFTC'S rule book regulation 1.25 that regulates the types of collateral that is acceptable for margining and for FCMS to hold and that mainly is around liquid stable assets and so they will have to look at that.

Walt Lukken (23m 26s):

I think our view is there doesn't need to be significant changes in the CFTC rules in order to accept this, that it's flexible enough in a principle space regulatory regime to allow the underlying technology of what tokenization brings is as acceptable collateral. So in this paper we did over the summer, we have a legal analysis as part of the append that sort of goes into some of that, that we don't see major changes needed. There may be guidance needed in other things. So those will be the two things, you know, getting the prudential regulators to regulate the product but then in getting the market regulators to look at their regulations. But on the market side, I don't see as much of a heavy lift as on just the prudential regulatory side.

David Greely (24m 14s):

And you mentioned earlier that you could see this bringing more transparency to a lot of operations. Are there some other things you are looking at when you see this movement towards tokenization that could de-risk markets and actually make them more straightforward to regulate?

Walt Lukken (24m 33s):

Well I think there are lots of applications being, because this is moving assets to DLT to a ledger, there is still lots of applications that can be built on that. I think at first people were nervous that DLT meant that you can't see these, the audit trail of all these trades and where the assets are and I actually think it's quite the opposite and as we get smarter on these, these things and we can develop smart contracts, things like right now trades happen and then manual systems capture those trades and we have to report those trades to the regulators and we got to report the positions to certain people and we're doing this globally, but just think if a trade happens and it's a smart contract and you plug into that trade report here and file here and this could be automating things in the future that we just haven't even contemplated and you could take significant costs out of the system if we can do this right. So I think the fundamental technology of DLT Blockchain is going to really change what we do, how we do it and as an industry and we are just starting to scratch the surface, but first we got to build the rails. Once we do that, we can start to build the apps on top of it.

David Greely (25m 57s):

And you mentioned that you have been on the road quite a lot over the past month or two FIA Chicago then the conference in Singapore and I am sure quite a few others on a personal level, is there any conversations you have heard or approaches you have seen that have gotten you the most excited?

Walt Lukken (26m 16s):

One of the companies that we have been briefed on is DTCC is doing some interesting things on tokenization and they seem pretty advanced on the topic and I know NASDAQ announced at our Boca conference this year that they are moving to 24x5 trading in two years. So it's still a ways off, but they are working with DTCC to figure that out. And so for me the excitement is like the collaborative energy of growth. I mean because this represents growth in our markets for years, for a decade plus. We have been talking about the rules and regulations post-financial crisis and now is a time where we are like, okay, let's figure out how we can safely grow our markets using new technology that provides more access to people globally and we are seeing an explosion in our markets around the world. For me, it's an exciting time as I talk to people. It's anxiety ridden too because it, it's about change, right? I mean, people don't like change, but I look at it really high level. People are interested in our markets. There is demand for our markets and our products. We should be blessed and happy that that is the case and we just have to be resilient and move along with the change and it's going to be a big positive for our industry.

David Greely (27m 36s):

And you have been a big proponent and supporter of innovation and growth in these markets. As you said, not everybody enjoys change. It can be painful and also it brings a lot of new people into the markets. How much are you seeing, like even the, the makeup of the FIA changing in recent years as there has been more technology and tokenization efforts brought in.

Walt Lukken (28m 02s):

I do see it in over the years we worried that our industry was aging, you know, that it was not bringing in an a youth generation. How do we do that? How do we get people excited about our, our industry Here it is. Like we are starting, like at our Asia conference, we saw a lot of young people who are interested in our markets, are interested in these new platforms that are happening and they think differently about money than our generation thinks about money. And we should embrace that. And it's not that we are throwing away the lessons and the infrastructure of our generation. There's a lot of value there and good things that we have built over time, but we also shouldn't dismiss these new markets, this evolution, this innovation as you say, to me that's a, the exciting, that's the energy that our industry should be embracing and it's going to be a wonderful innovative 2026 as we head into the New Year.

David Greely (29m 04s):

Thanks again to Walt Lukken, President and CEO of the FIA and Former Acting Chairman of the US Commodity Futures Trading Commission. We hope you enjoyed the episode. This concludes our series Re-Engineering Tokenization. We will be back next week with our end of year Holiday Special episodes. We hope you will join us.

Announcer (29m 27s):

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