

FESE response to the IOSCO consultation on Decentralised Finance (De-Fi)

19th October 2023

Q1: Do you agree with the Recommendations and guidance in this Report? Are there others that should be included?

FESE generally agrees with the recommendations outlined in the IOSCO report. We would like to highlight the following aspects.

In Recommendation 1, IOSCO underlines that regulators should analyse DeFi products, services, arrangements, and activities with the view to applying its Existing Framework or New Framework, in accordance with the principle of “same activity, same risk, same regulatory outcome”. IOSCO also states that to do so, a regulator should achieve a holistic and comprehensive understanding of such DeFi products, services, arrangements, and activities. FESE believes that the international De-Fi regulatory framework must maintain a technology-neutral approach. Within this approach, existing principles of “same business, same risks, same rules” should apply where possible but, at the same time, should consider De-Fi specifics as well. In doing so, the technology-neutral approach, existing principles and De-Fi specifics should positively impact and uphold the values of transparency, fairness, stability, investor protection, and market integrity. In addition, regulators should ensure that the De-Fi framework is aligned with existing regulations (e.g. the MiCA Regulation). Duplicated regulations should be avoided, and there should be a tailor-made regulation for De-Fi that is adapted to its specific characteristics and risks. FESE agrees that the De-Fi financial regulation requires an understanding of the totality of the De-Fi ecosystem and its interrelation with Ce-Fi, TradFi, and other actors, as outlined in the guidance section of Recommendation 1.

In Recommendation 2, IOSCO stated that a regulator should aim to identify the natural persons and entities of the DeFi arrangements that could be subject to its applicable framework. FESE agrees that the functioning of the De-Fi system sparks numerous questions as to formal legal accountability in cases of fraud and mismanagement of the system. Given that transactions take place in a cross-border scenario, it is not clear which jurisdiction would apply in the cases of violations. Considering that anyone can participate in the trading in an anonymised manner, it is difficult to establish which party to hold to account in cases of fraud. Smart contracts are also often coded by numerous programmers or even an “open source” that potentially allows anyone to change its content. Accordingly, De-Fi functioning raises questions of who is liable in cases of mismanagement of the system and how to ensure there is a legal recourse to bring the responsible parties to account. FESE agrees that it is crucial for smart contracts to have identified “owner(s)” or “operator(s)” who will be responsible for their management.

In Recommendation 9, IOSCO underlines that regulators should seek to understand the interconnections among DeFi arrangements, the broader crypto-asset market, and also the traditional financial markets. Although De-Fi is predominantly a self-referential system and its interrelation with the traditional financial system remains thin, it still can

pose risks to financial stability. In the future, there is a possibility of the De-Fi system becoming more interconnected with TradFi through the development of more cross-market products that can be accessed both in De-Fi and Trad-Fi. As a result, greater price fluctuations in crypto asset markets might have a greater impact on the traditional financial system. Therefore, there is a need for an international cross-border framework to address the De-Fi risks and their potential impact on financial stability.

Q2: Do you agree with the description of DeFi products, services, arrangements, and activities described in this Report? If not, please provide details. Are there others that have not been described? If so, please provide details.

Q3: Do you agree with the Report’s assessment of governance mechanisms and how they operate in DeFi? If not, please provide details.

Q4: Do you agree with the risks and issues around DeFi protocols identified in this Report? If not, please provide details. Are there others that have not been described? If so, please provide details. How can market participants help address these risks and/or issues, including through the use of technology? How would you suggest IOSCO members address these risks and/or issues?

FESE agrees with the risks and issues outlined in the report, in particular with those stemming from the issue of identification of responsible parties. Considering that anyone can participate in the trading in an anonymised manner, it is difficult to establish which party to hold to account in cases of fraud. Smart contracts are also often coded by numerous programmers or even an “open source” that potentially allows anyone to change its content. Accordingly, De-Fi functioning raises questions of who is liable in cases of mismanagement of the system and how to ensure there is a legal recourse to bring the responsible parties to account. As a potential solution to increase transparency and compliance, there are initiatives to develop “permissioned” De-Fi models where access to De-Fi platforms is only granted to identified entities or individuals. In the “permissioned” De-Fi, a centralised entity whitelists participants for the De-Fi protocol, while still offering decentralised benefits outside of this function.

There are also significant risks of money laundering and terrorist financing as many De-Fi products and services do not have requirements to abide by AML/CFT rules. Additionally, there is always a risk that a traded coin is “tainted” as it could come from a wallet that is connected to illicit activities. In current market practices, firms decide based on their own assessment how much risk they are willing to take, as any coin could become “tainted”. Therefore, companies need to develop risk assessment methods when deciding on how to proceed with such “tainted” coins. Additionally, the whole industry would benefit from industry-wide standards and guidance.

Due to its decentralised nature and complexity, the regulation of De-Fi is a challenging task that requires careful consideration. FESE supports that regulators take the time to understand the developments and assess at a later stage, and if so, how to regulate De-Fi. Ce-Fi institutions, however, should be allowed to enable easy, reliable, and efficient access (on and off ramping) to De-Fi applications. They would act as trustworthy

intermediaries and build a regulated bridge between Ce-Fi and De-Fi. It is important not to “overburden” the requirements for regulated players to enter and test the new space by trying to adapt to the same safeguards known from traditional asset classes. Meanwhile, one could try to facilitate the interactions between regulated players and DEXs. One way to do this could be to allow regulated Financial Market Infrastructures (FMIs – such as regulated markets, multilateral trading facilities, CCPs, CSDs) to interact with DEXs, after validating the “minimum” technical standards of a smart contract in question and involving independent technical auditors. Additionally, since Ce-Fi institutions are able to comply with regulatory standards by fulfilling AML criteria, CFT, and KYC, and ensuring investor protection, they can provide users with security and reliability in using De-Fi applications.

Q5: Do you agree with the description of data gaps and challenges in the Report? If not, please provide details. Are there others that have not been described? If so, please provide details. How can market participants address these data gaps and challenges, including through the use of technology? How would you suggest IOSCO members address data gaps and challenges?

We agree that risk management needs to be taken seriously in the DeFi world. As we have seen in the CeFi world, traditional failings can and have caused widespread investor harm. We generally agree with the assessment and applaud the decision to carefully scrutinise risks attendant to DeFi before prescribing a regulatory framework.

Underlying the question of regulating DeFi is the distinction between the investment and technology sides of the crypto ecosystem. The investment side looks very much like traditional finance. The technology side, on the other hand, is the part of the ecosystem that is trying to make these global, permissionless distributed ledger systems actually useful for a variety of activities. This side looks very different from traditional finance, as its functioning is determined by cutting-edge computer programming and network building. It is the technology side that introduces novel risks which we should be careful to understand before we apply regulations. In some instances, public policy may not be the best answer for certain risks. Rather, the technology itself must evolve to address certain consumer protection, security, and other issues.

Therefore, we would caution that the use of public permissionless blockchains/DLTs is being restricted. It is comparable to the internet - which is also open, publicly available and thus not bad per se, but it depends on the applications/services offered based on it. The same is true for public blockchains - TradFi companies may use the public DLTs just as they use the internet as they bring innovation; it's more important to ensure that the services offered based on it are safe and serve the investors.

Q6: Do you agree with the application of IOSCO Standards to DeFi activities contained in this Report? Are there other examples of how IOSCO Standards can apply?

Q7: Is there any additional guidance that you would find relevant to help IOSCO members comply with these Recommendations? If so, please provide details.

Regulation of DEXs will prove to be a difficult task for regulators and policymakers: whether to regulate at the protocol level or the app level and who in reality owns and is responsible for the protocols, smart contracts, and the apps. One of the possible regulatory approaches could be to regulate the issuance and management of smart contracts. However, it would be a challenging task as supervisors will need to control the

technology used (“smart contract audits”) and the coding skills of programmers. Moreover, it could potentially undermine the technology neutrality principle by prescribing technology-specific parameters. In FESE’s view, it is crucial to keep the balance between innovation and safety for financial markets. From an operational perspective, a potential approach should be more detailed but avoid recommending technology-specific parameters. For example, including the disclosure of material information similar to those applicable to TradFi about products, services, and underlying entities in an understandable way. Additionally, the regulatory approach should focus more on the education of users of potential risks stemming from De-Fi rather than restriction of their participation in DEXs trading.

Q8: Given the importance of the application of IOSCO Standards to DeFi activities, are there technological innovations that allow regulators to support innovation in DeFi/blockchain technologies while at the same time addressing investor protection and market integrity risks? If so, please provide details.

There is a middle ground between traditional trading and the use of DEXes. In situations where fully-fledged decentralised exchanges are not suitable, there is still a possibility to introduce certain DEX-specific mechanisms to traditional exchanges. They would benefit from new blockchain-based efficiencies while maintaining regulatory certainty. An example of such solutions could be the use of DEX-specific Automated Market Makers and liquidity pools on a traditional stock exchange to supplement the CLOB model.

Q9: Are there particular methods or mechanisms that regulators can use in evaluating DeFi products, services, arrangements, and activities, and other persons and entities involved with DeFi? If yes, please explain.

As mentioned earlier, regulated Ce-Fi institutions could provide an array of safeguards and reliability to the world of De-Fi. In this regard, activities of Ce-Fi institutions in enhancing the decentralized networks’ integrity, e.g., by contributing to the consensus mechanisms or by running nodes for the networks, should be encouraged. It is worth mentioning that consensus mechanisms are not De-Fi products or services and, thus, are free from some of the risks of other financial activities (e.g., counterparty risks). Furthermore, protocol mechanisms are the necessary foundation for blockchains’ integrity on which De-Fi products and services are built. Hence, the industry should foster this nascent array of services, policymakers should regulate them, and Ce-Fi institutions should contribute to upholding their integrity.

Q10: Do you find the interoperability between this report and the IOSCO CDA Report to be an effective overall framework? If not, please explain.