
Blockchain For Europe – Public Comment on IOSCO’s Consultation Report on Policy Recommendations for Decentralized Finance (DeFi)

Blockchain for Europe (BC4EU) and its members welcome the opportunity to provide feedback to IOSCO’s attempt to address potential market integrity and investor protection issues in Decentralized Finance (DeFi). We strongly believe the complexity of DeFi requires close worldwide cooperation that would facilitate the exchange of information among key regulatory and standard-setting bodies, and therefore ensure a common understanding. Such common understanding needs to be based on clear unified definitions that are accepted and respected globally.

We believe many of the questions posed by IOSCO in its consultation document are linked to a political and ideological discussion. BC4EU represents blockchain and crypto companies of various sizes and business models, and thus, in our response to the consultation, we focused on presenting key comments and observations that need to be addressed before any effective Recommendations can be drafted. Our members’ input has been consolidated mainly as an answer to Question 1, as well as an additional response to Q6 (please see the last bullet point). We hope to build on this input in subsequent discussions with IOSCO and its members, as global authorities mature their work assessing appropriate and proportionate regulatory approaches to DeFi.

We would welcome the opportunity to discuss this further with the IOSCO in the coming months.

Question 1: Do you agree with the Recommendations and guidance in this Report? Are there others that should be included?

Blockchain For Europe (BC4EU) respectfully disagrees with the approach taken by IOSCO in the Recommendations and urges the organization to take into consideration the following points to develop an effective and clear policy framework that can assist member jurisdictions when developing national rules to address market integrity and consumer protection risks in decentralized finance (DeFi). We are concerned that given the lack of a common understanding globally about DeFi and clear definitions, the Recommendations are not only unlikely to be effective, but might end up creating adverse consequences. This legal uncertainty creates additional risks for participants in the space, who may not be able to identify a “Responsible Person”, thus remaining ‘non-compliant’. Furthermore, the misconception around DeFi presented in the Recommendations may create uncertainty as to how these guidelines should be applied in practice, causing additional compliance-related questions and confusion.

Below, we have outlined some key points to take into consideration as the organization continues its work to create effective Recommendations for members to develop policy frameworks for decentralized finance:

- **Decentralized finance needs to be properly defined to ensure regulatory clarity and legal certainty.**

The main shortage of IOSCO's recommendations is a lack of understanding or a choice to disregard what "true" DeFi is, without which any other recommendation or guideline loses any purpose and concrete objective. We believe that clear definitions are paramount to ensure legal certainty and a common understanding of a nascent industry. The document presents policy recommendations on DeFi but does not provide a definition of what is understood as DeFi, which should be addressed in the first place. The absence of such definitions introduces further legal uncertainty and ambiguity to the understanding of DeFi amongst regulators. As such, the policy assertion cannot be assumed to be legally correct and fully agreed upon by all IOSCO members. Furthermore, regulators and international standard-setting bodies are only now developing their reports on DeFi – the FSB and IOSCO report is not expected to be completed until late 2024, whereas the European Commission's report on DeFi should arrive by the end of 2024.

The Recommendations, although implicitly recognizing that truly decentralized arrangements may exist, claim that it will be possible to identify one or more "Responsible Persons" through a very broad interpretation. This contradicts the true decentralization nature of such arrangements. The confusion comes from the fact that, what Recommendations describe are not truly decentralized systems and how to potentially apply the IOSCO principles to these, but rather "Decentralized-In-Name-Only" (DINO) arrangements, that are centralized, in which case the principles can be applied as is (described in the previous Recommendations for Crypto and Digital Assets Markets).

In addition, we believe that the differentiation between - and discussion of - truly decentralized arrangements and ones that only pretend to be decentralized is one of the aspects the Recommendations could have usefully contributed to, providing valuable insights on how to identify points of centralization and define what level of control justifies being "responsible". This is one of the points being discussed broadly in the European Union as the separating line used in the EU's Markets in Crypto-Assets Regulation (MiCA) to identify which entities (intermediaries) would be captured by the rules. Regulators should therefore focus on differentiating between (true) DeFi and other services that are centralized/decentralized-in-name-only, as the latter do not require new rules or recommendations, as these already exist.

To achieve clarity on this front, BC4EU suggests introducing the following definition of "Decentralization" which can then be used to reach an understanding of what a "true DeFi arrangement" is:

"A blockchain network is considered to be "truly decentralized", when there is no one who holds a unilateral ability, directly or indirectly, to control the network or alter data, either historical or new additions".

- **The concept of a ‘Responsible Person’ does not apply in true DeFi arrangement.**

The Recommendations rely on the identification of a “Responsible Person” in DeFi arrangements, as stipulated in IOSCO’s Recommendation 2. The notion of a “Responsible Person” includes those that “exercise control or sufficient influence over Defi arrangement.” As explained in our point above, the fundamental principle behind decentralization, and thus true DeFi, relies on the lack of “control” by any party or entity. For this reason, despite the existence of various actors in the DeFi space (i.e., software developers, data aggregators or interface providers), none of these hold an actual control over a DeFi arrangement, therefore such criteria is simply not applicable. This is because “control” goes against the principles behind decentralization, which assumes no one has control over the network and should thus ultimately be held responsible. We would like to stress that Regulators should identify “Responsible Persons”, as they do in traditional financial services regulation, but only IF there is a “Responsible Person” to identify. At the same time, we believe that it would be most fair to agree that the burden of proof to show that a person or an entity holds the control over the DeFi arrangement should be on the regulator, and not on the entity or person that the regulator may consider holds a control.

Furthermore, the document creates additional ambiguity by not clarifying what such “Responsible Person” is responsible for or what is meant by “sufficient influence” – which may cause discrepancies in interpretations among regulators. The Recommendations build on this notion introduced in the Financial Action Task Force’s (FATF) Updated Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers, but neither this Guidance nor the current Recommendations clearly indicate *how* to identify “Responsible Persons”, as they simply list actors that could be held responsible if one is not easily identifiable. Importantly, the Guidance does acknowledge that FATF standards do not apply to the underlying software or technology behind DeFi.

The reliance on this identification of a “Responsible Person”, and the use of unclear language, is a real concern for regulators that would need to focus their limited resources on trying to identify a “Responsible Person”, rather than on implementing concrete risk mitigation strategies. It is worth mentioning that the latter could be undertaken using the technology itself, i.e., by taking advantage of blockchain analytics to help track illicit funds.

- **Regulated entities that classify as Crypto-Asset Service Providers cannot be true DeFi arrangements.**

Financial services regulation focuses on intermediaries. In the crypto-asset market, crypto-asset service providers (CASPs) are rightfully regulated as the intermediaries allowing users to use crypto-asset services.

True DeFi arrangements, however, are in principle ‘disintermediated’, meaning that there is no intermediary having a unilateral ability to alter the state of the network or restrict access to it.

Because of this, IOSCO’s assumption that certain regulated entities that already fall within the scope of existing regulations may be carrying out “DeFi activities” cannot be true. Regulated intermediaries might be interacting with true DeFi arrangements, but they cannot be “in control” of them. Otherwise, these would not be “true DeFi” arrangements but rather (partially) centralized “CASPs” with identifiable “Responsible Persons”.

Overall, the challenges highlighted in the IOSCO paper are more aligned with current operational supervisory issues for regulators, rather than representing a fundamentally new issue that is inherent to the DeFi space and its underlying technology. Focusing on centralized actors, capable of identification and compliance with existing regulations, is not new and is not a DeFi issue. Regulators already have the tools to regulate centralized entities within their mandates, including those considered to be operating without the correct authorizations.

For example, even if an existing regulated entity licensed for its financial service activities begins interacting with the DeFi space one way or the other, this should not suddenly make the entity non-compliant with existing regulations.

While we agree that financial intermediaries should be regulated, it is important to stress that there are certain actors in the DeFi ecosystem who are not financial intermediaries and should not be subject to such regulation. These include technology and infrastructure providers such as non-custodial wallets, miners/validators, providers of APIs and various types of software providers, and anything that is decentralized. They are not regulated in the traditional world as financial intermediaries and should not be regulated in a DeFi world purely because they utilize the blockchain, particularly when technology neutrality is emphasized in financial services policy and regulation. On this basis, we oppose attempts to regulate non-intermediaries and particularly attempts to regulate them like intermediaries.

Until true DeFi is clearly defined, IOSCO’s policy solutions are unlikely to be effective or reflect the scope of what should be regulated as DeFi. This could risk duplication or overreach within IOSCO members’ mandate in terms of services and activities regulated, but also technology and/or infrastructure itself should not be regulated directly.

- **Regulating technology is not the core remit of financial regulators.**

The Recommendations should focus on the core functions and activities conducted within DeFi, if these fall within its regulatory scope, not the technology or supporting infrastructure itself. As in the case of traditional finance, the infrastructure and ecosystem supporting DeFi are interconnected across other industries and sectors that may not be within the scope of financial regulations but are important to the wider digital economy.

- **DeFi is a rapidly evolving field and policy responses should be flexible and adaptable to accommodate new technology and its new risks.**

It needs to be stressed that due to the decentralized nature of DeFi, the application of existing rules used in the incumbent system could force centralization or use of intermediaries, and therefore eliminate the potential efficiency gains related to the use of DeFi. Rigid regulations may stifle innovation and hinder the growth of DeFi in the long term. For this reason, it is important to carefully balance the need for oversight and supervision with the desire to foster innovation and maintain the core principles of DeFi, especially in such an early stage of development of the sector. Decentralized character of DeFi arrangements helps to mitigate certain risks that are a product of centralization, while new risks appear including hacks, scams, or smart contract vulnerabilities. We believe that it is a reasonable approach to allow additional time to assess and monitor DeFi specifically to ensure any potential regulation is appropriate. In this regard, the main focus of regulators should be on the benefits and risks of DeFi and its associated infrastructure.

Moreover, in order to ensure an effective solution for the DeFi space, a collaboration between regulators, industry stakeholders, and the DeFi community is essential - as is also indicated in recommendation 1. Such cooperation could facilitate the exchange of information, awareness-building, and education among both regulators and market participants to ensure a common understanding of the risks and opportunities in DeFi, while also helping to eliminate some of the common misconceptions around DeFi. Finally, it would contribute to the development of a regulatory capacity and expertise that would be prepared to effectively oversee this new global industry.

- **Coordination and global cooperation are necessary to achieve clarity and harmonization.**

Global collaboration by regulators remains crucial because nearly everything in DeFi is instantly global in nature and operates day and night unlike Traditional markets, but rather like the internet. Coordinated efforts and international cooperation among regulators will be necessary to effectively address regulatory challenges in this space. We support the objective of achieving minimum global standards, supported by cross-border cooperation and information sharing across jurisdictions, to help ensure optimal consistency in the way DeFi markets are regulated within individual IOSCO jurisdictions. We would also encourage regulatory convergence on definitions and approaches with other international bodies and regulators among different jurisdictions and sectors, including the FSB, BIS, and FATF, as well as national central banks and other regulatory bodies.

To facilitate these efforts, a new body consisting of the main financial and technological standard -setting bodies could be considered to set appropriate standards globally and encourage international interoperability and cooperation. The involvement of non-financial standard setting bodies would be key considering how the decentralization of the DeFi sector

brought by blockchain technology is not only relevant for the financial sector but will play a role in many different economic sectors.

- **An understanding of governance mechanisms is necessary for the proper assessment of DeFi arrangements.**

The specific governance mechanism is at the core of understanding every blockchain, as it is a system for managing and implementing changes in its ecosystem. A governance mechanism plays an important role in understanding DeFi arrangements and its functioning as a whole. Depending on what type of governance mechanism is in play, a given DeFi arrangement may be exposed to different risks, including the risk of concentration of power, i.e. when an intermediary has the potential to take control of a DeFi arrangement. It is for this reason essential that regulators have a solid understanding of governance mechanisms of an underlying DeFi arrangement when assessing what true DeFi is in order to ensure effective regulation.

- **The blind application of IOSCO Standards to DeFi activities does not present the right approach (Question 6).**

We do not agree with the application of IOSCO standards to DeFi activities contained in this Report, as explained in our answer to Q1. The proposed policy recommendations do not properly define DeFi, do not take into account its decentralized nature, but instead apply the same regime as for traditional finance, which may not always be relevant, considering the unique risks and benefits associated with DeFi.

In addition, as mentioned already in our answer to Question 1, we believe that the Recommendations disregard the existence of true decentralization. Instead, IOSCO's working assumption in the proposal is that DeFi is not really DeFi but decentralized-in-name-only (DINO), which is not always the case. Proper classification of DeFi arrangements as truly decentralized requires clear definitions, which are not provided in the document. For this reason, we would like to once again encourage IOSCO to support the development of a globally consistent definition and taxonomy for DeFi. Any such definition and taxonomy should consider the unique nature and structure of DeFi, to determine the level of decentralization and regulations should be calibrated accordingly.