



WFE Response to ACPR Public Consultation: “Decentralised” or “disintermediated” finance - what regulatory response?

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Background

The World Federation of Exchanges (WFE) is the global industry association for exchanges and clearing houses. Headquartered in London, it represents 250 market infrastructure providers, including standalone CCPs that are not part of exchange groups. Of our members, 25% are in Asia-Pacific, 58% in EMEA and 17% in the Americas. WFE's 91 member CCPs collectively ensure that risk takers post some \$1.3 trillion (equivalent) of resources to back their positions, in the form of initial margin and default fund requirements. WFE exchanges are home to 57,656 listed companies, and the market capitalization of these entities is over \$101.17 trillion; around \$146.29 trillion (EOB) in trading annually passes through WFE members (at end 2022).

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for all sorts of companies and market participants wishing to raise capital, invest, trade, and manage financial risk.

Established in 1961, the WFE seeks outcomes that maximise financial stability, consumer confidence and economic growth. We also engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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Q1: Do you have any comments on the definition of DeFi used in the paper? Does the document correctly reflect the real level of decentralisation of services?

The World Federation of Exchanges agrees that DeFi is another way to enable financial services that carries many of the same risks as traditional financial services and trading of assets. The paper does a good job elaborating on the difficulties of defining DeFi. In the context of crypto-asset trading platforms, the idea of decentralisation is a misnomer. A platform where buyers and sellers meet is, by its very nature, a central entity.

While DeFi platforms are often marketed as decentralised, they still have some central elements, allowing regulators to 'hook onto' the application level of the services being offered which can ensure a technological neutral approach. This illusion in decentralization is also apparent through the governance models used in DeFi through DAOs, which can lead to power concentrations and inefficiencies, especially if a singular interest captures a significant amount of governance tokens.

Regarding the real level of decentralisation of DeFi services, we agree with the paper's assessment that decentralization can be an "illusion" and that many DeFi services replicate traditional financial services with weaker regulation and increased risks for investors. A platform where buyers and sellers meet is, by its very nature, a central entity. Establishing a proper taxonomy of the various products and services being offered in the crypto arena is a crucial first step in any attempt to regulate. It is understandable that regulators and standard setters are hesitant to undertake this work.

The use of the term 'decentralised exchange' implies something which it may not be. We have already established that it's a misnomer itself. But it may imply that no one person is in control. The ACPR recognises that this is not always the case and we expand on this point further in question 3. The risk of this implication is clear – investors can, will be and are misled by the name.

Q3: What do you think about the concentration phenomena described in section 1-5 of this document?

As the WFE, we are concerned about the concentration of governance tokens in DeFi platforms. This concentration can result in decisions being made that are not in the best interests of the protocol or the wider community, especially if those with the tokens have conflicting interests or engage in fraudulent activities. This can lead to a loss of trust and undermine investor confidence in the entire blockchain ecosystem. Moreover, we know from traditional finance that decentralised governance models can be inefficient.

These problems are far from theoretical, Ethereum's recent switch to proof-of-stake from proof-of-work was largely driven by a central team at the Ethereum foundation. While "The Merge" – as it has come to be known – has reduced Ethereum's energy usage by 99%, it also shows that a central actor, or set of actors, can take control of a decentralised blockchain platform. Issues like these have led to international standard setters like the Bank for International Settlements to label decentralisation an "illusion" and for the International Organisation of Securities Commissions (IOSCO) to determine that most of the new services in decentralised finance which are emerging "replicate more traditional financial services and activities, but with weaker regulation and increased risks for investors."

As an industry group representing over 250 market infrastructures around the world, the WFE seeks to ensure regulatory outcomes that foster well-functioning capital markets. Decentralised governance in the DeFi ecosystem should be subject to best practices and standards to protect investors and to establish and maintain trust in the blockchain ecosystem as a whole.

Q5: Do you have any comments on the description (provided in section 2-1 of this document) as regards risks related to decentralised governance?

In our view, the paper accurately explains the risks related to decentralised governance. The mentioned risks related to decentralised governance can be an issue for investors because they can lead to decisions that are detrimental to minority owners. If the governance tokens are concentrated in the hands of a few players, those players may make decisions that are not in the best interest of the protocol or the wider community. Additionally, the founders or developers of a protocol may retain a majority of the governance tokens, giving them the power to make decisions without the agreement of the decentralized governance bodies. This can be particularly concerning if those parties have conflicting interests or engage in fraudulent activities. Overall, the risks associated with poor governance can lead to a loss of trust in the protocol or the wider DeFi ecosystem, which can have negative consequences for investor and also financial market infrastructures.

Two areas where the paper could further expand are the limits to decentralisation of governance and the limited knowledge of governance token holders. Starting with the limits of decentralisation of governance. Put simply, decision-making takes longer when there are more parties involved. This could be particularly problematic in times of financial stress. Moreover, where decision-making is so diluted, it becomes difficult to ensure for accountability.

The limited knowledge of governance token holders is also an issue. In a traditional financial firm, a decision-maker will have had to have shown a degree of expertise to get to where they are and will frequently be required to pass a 'fit and proper' persons test. To hold a governance token, one does not need to be an expert or even understand the issue being voted on. In contrast to traditional shareholder votes, governance token votes can be taken on day-to-day business decisions. Whilst FTX would not be considered decentralised, the recent crisis surrounding it is a stark reminder of the dangers of a complete lack of effective governance.

Q10: Do you have any comments or additions to make to the description (provided in section 2-4-2) of the systemic vulnerabilities of the DeFi ecosystem (endogeneity of investments, significant leverage effects, role of automated position liquidation mechanisms)?

In addition to the description provided in section 2-4-2, the systemic vulnerabilities of the DeFi ecosystem could pose a significant risk to the custody of the crypto assets involved in those services. Custody is a critical aspect of the cryptocurrency market, and any breach or hack could lead to the loss of a significant amount of assets.

One major vulnerability in the DeFi ecosystem is smart contract risk. If these smart contracts are not adequately audited, tested, or secured, they could contain vulnerabilities that could be exploited by attackers. If such an attack were to occur, it could result in the loss of assets held in the contract.

Another risk is the possibility of liquidity and price shocks. Decentralised exchanges (DEXs) that are part of the DeFi ecosystem operate using automated market makers (AMMs) that allow users to trade assets directly with each other without intermediaries. However, these AMMs are vulnerable to flash loan attacks, where an attacker can borrow large amounts of assets from the DEX and manipulate the market to cause a price shock.

Furthermore, if a hack or exploit occurs, the assets held in the smart contracts or DEX could be stolen, and the owners of the assets could suffer significant losses. Additionally, if the DeFi ecosystem experiences a liquidity crisis, it could lead to a loss of value of crypto assets, which could impact the overall value of the holdings of custodians who hold

those assets. These are some of the reasons that some institutional investors may still be concerned with engaging in the DeFi space.

Q13: In your opinion, are there any other risks that should be taken into account which are not mentioned (or not given sufficient attention) in the document?

One of the main problems regulators have with DeFi is identifying who or what to regulate; or, what they can 'hook' regulation to. Regulators can apply regulation on the applications, which helps to ensure that a technological neutral approach is adopted.

Q14: Should public blockchains be governed by a framework or by minimum security standards (refer to section 3-1, regulatory scenario A)?

Yes. Public blockchains are decentralised by design, which means that there is no central authority to govern them. However, there are several ways in which public blockchains can be governed by a framework or minimum security standards.

One way is through community-driven governance. In this model, the blockchain community itself is responsible for making decisions about the direction and operation of the blockchain. This can be done through a decentralised decision-making process, such as a DAO (decentralised autonomous organisation), where token holders can vote on proposals and changes to the blockchain.

Another way is through a set of minimum security standards that all participants in the blockchain must adhere to. This can be achieved through the use of smart contracts, which can enforce rules and regulations that ensure the security of the blockchain. For example, smart contracts can be used to enforce minimum transaction fees, minimum node requirements, or minimum storage requirements for participating in the blockchain.

Additionally, public blockchains can be governed by a set of rules and regulations that are enforced by a regulatory authority. This can help ensure the security and integrity of the blockchain, but it may also limit the decentralized nature of the blockchain. Overall, the governance of public blockchains is a complex issue that requires a balance between decentralisation and security.

Q31: Do you agree with the description provided of the risks associated with "CeDeFi" on the one hand and "crypto conglomerates" on the other (box 6)?

Vertical integration is, by itself, not a concern. Vertical integration can reduce costs for companies and customers, improve quality and consistency of the product, foster innovation and, provide benefits in terms of risk management. Market infrastructures in the TradFi world frequently operate a vertically integrated model well.

Crucially, it is important to have proper conflicts of interest management when operating a vertically integrated model. Vertically integrated exchange groups manage conflicts of interest through approaches such as functional segregation, ethical walls/information barriers, clear policies and procedures, independent oversight, disclosure and transparency,

training and education, and compliance with regulations. These measures are designed to prevent conflicts of interest, ensure transparency, and protect the interests of stakeholders such as investors and market participants.

One area where exchange groups do not engage with is proprietary trading against clients. We see that this is a common phenomena in crypto-markets and one of the issues that arose during the FTX crisis. We do not consider that there is anyway in which to adequately manage the conflicts of interest that arise as a result of this type of activity nor do we think that any trading platform should be able to call itself an 'exchange' whilst undertaking these activities.