WFE Response to IOSCO: CR04/2023 Policy Recommendations for Decentralized Finance (DeFi)

19 October 2023

Background

Established in 1961, the WFE is the global industry association for exchanges and clearing houses. Headquartered in London, it represents over 250 market infrastructure providers, including standalone CCPs that are not part of exchange groups. Of our members, 34% are in Asia-Pacific, 45% in EMEA and 21% in the Americas. WFE's 90 member CCPs and clearing services 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, together with other exchanges feeding into our database, are home to over 50,000 listed companies, and the market capitalisation of these entities is over $100 trillion; around $140 trillion (EOB) in trading annually passes through WFE members (at end 2022).

The WFE is the definitive source for exchange-traded statistics and publishes over 350 market data indicators. Its free statistics database stretches back more than 40 years and provides information and insight into developments on global exchanges. The WFE works with standard-setters, policy makers, regulators and government organisations around the world to support and promote the development of fair, transparent, stable and efficient markets. The WFE shares regulatory authorities' goals of ensuring the safety and soundness of the global financial system.

With extensive experience of developing and enforcing high standards of conduct, the WFE and its members support an orderly, secure, fair and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise the common good, consumer confidence and economic growth. And we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in a globally 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 agree with the Recommendations and guidance in this Report? Are there others that should be included?

The World Federation of Exchanges (WFE) is very supportive of all nine policy recommendations by IOSCO. We have set out some short thoughts in response to each recommendation below.

Recommendation 1 – Analyze DeFi Products, Services, Arrangements, and Activities to Assess Regulatory Responses.

WFE Comment: We concur with the report's evaluation that the notion of "decentralisation" in Decentralised Finance (DeFi) services can often be more illusory than real. Many of these services essentially mimic traditional financial mechanisms but with less oversight and greater risks to investors.

The first crucial step towards regulating them is to accurately categorise the different products and services within the crypto space. We note, in particular, that the label 'decentralised exchange' may suggest something it is not. It might give the impression that the platform is without centralised control, an assumption the IOSCO points out is not necessarily true. It might also give the impression that it is regulated and can be trusted to have certain controls in place like a traditional exchange. This is why the WFE has consistently campaigned for crypto 'exchanges' to be called crypto trading platforms. The risk arising from this misleading terminology is evident: retail investors can be, and often are, misled by the terminology.

The WFE encourages IOSCO to distinguish between "DeFi protocols" and "DeFi applications". We suggest using the term "DeFi protocol" instead of "DeFi application" to describe the set of software and smart contract protocols that are built on blockchain infrastructure. As users don't have a way to interact with these protocols without the use of further tools, interfaces, or wallets, the term "DeFi application" does not accurately represent the nature of the protocol, particularly when compared to what IOSCO describes as "centralised applications", such as centralised trading platforms, data analysis platforms, or oracles, that can be used and interacted with directly by end users.

Recommendation 2 – Identify Responsible Persons

WFE Comment: We welcome the reports focus on identifying responsible persons and holding them to account, much like a regulator of traditional financial services would. As IOSCO notes, de-centralised entities often act automatically but they do not arise out of nothing. These de-centralised entities are created, developed, and governed by groups of people. Those persons that exercise control or sufficient influence over a DeFi arrangement or activity should be identified in order to see if they meet standard regulatory requirements of honesty, competence, capability, and financial soundness. Holding controlling persons of DeFi applications and protocols accountable is a crucial aspect of delivering technology-neutral regulation in the rapidly evolving world of decentralised finance.

Nevertheless, recommendation 2 would benefit from more specificity. As proposed, it suggests an expansive view of who can be regulated as responsible persons, including both natural persons and entities, which makes it subject to confusion and a lack of enforcement. An entity can be regulated but within that people have accountability. Furthermore, the recommendation could be read so that it captures developers of code even if they are not offering services.

Recommendation 3 – Achieve Common Standards of Regulatory Outcomes

WFE Comment: The WFE concurs that DeFi can serve as an alternative avenue for financial services but also presents many of the same hazards found in the conventional financial sector. Therefore, we welcome the policy goal of achieving the same regulatory outcomes as those that are required in traditional financial markets. In particular, we welcome IOSCO's exercise mapping out the activities and services in DeFi in comparison to TradFi.

In principle, achieving similar regulatory outcomes for DeFi and CeFi (centralised finance) activities, focusing on consumer and investor protection, combating illicit finance, and preserving market integrity, is essential. However, it's also important, as with all regulation, to strike a balance to avoid stifling innovation and fostering regulatory arbitrage. Recognising that DeFi operates differently from CeFi is also pivotal; effective risk mitigation measures depend on understanding the unique technology and its evolution to manage specific risks effectively. Regardless, the key point here is that the model utilised does not automatically extinguish the risks or obligations for good governance and controls.

Recommendation 4 – Require Identification and Addressing of Conflicts of Interest

WFE Comment: We very much agree with IOSCO's attempts to address conflicts of interest in the DeFi world. As we have seen in the CeFi world, traditional failings with regards to conflicts of interest management can and have caused widespread investor harm.

One practice that exchange groups generally avoid is proprietary trading against their clients. This is a frequent occurrence in crypto markets and was a notable issue during the FTX crisis. We believe that there's no viable way to appropriately manage the conflicts of interest that emerge from such activities. Moreover, we argue that any trading platform engaged in these practices should not be entitled to label itself as an 'exchange.'

Recommendation 5 – Require Identification and Addressing of Material Risks, Including Operational and Technology Risks

WFE Comment: We agree that enterprise 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; its more important to ensure that the services offered based on it are safe and serve the investors.

Recommendation 6 – Require Clear, Accurate and Comprehensive Disclosures

WFE Comment: We agree with the need for clear, accurate and comprehensive disclosures. Much like exchanges in traditional finance vet products and are subject to rules which enforce disclosures, DeFi "exchanges" could implement similar measures.

Recommendation 7 – Enforce Applicable Laws

WFE Comment: The WFE supports the enforcement of applicable laws. Trust is fundamental to the functioning of a markets-based system and enforcement of applicable laws can help foster trust in the system.

Recommendation 8 – Promote Cross-Border Cooperation and Information Sharing

WFE Comment: The WFE supports cross-border co-operation and information sharing by regulators more broadly and in this case.

Recommendation 9 – Understand and Assess Interconnections Among the DeFi Market, the Broader Crypto-Asset Market, and Traditional Financial Markets

WFE Comment: We agree that IOSCO and regulators should further consider the interconnections between DeFi and CeFi as we understand that the two are deeply interconnected. We also agree that the two crypto worlds should be examined in relation to traditional financial markets but currently believe that traditional markets are somewhat isolated from crypto markets through this may change in future.

Possible areas for further recommendations:

We are conscious that this report should be read in conjunction with the Crypto and Digital Assets consultation. Nevertheless, for the sake of completeness, it is valuable to note three areas that are covered there but not in this report.

Firstly, vertical integration. Inherently, vertical integration is not problematic. It can offer advantages like cost reduction for both companies and consumers, enhancement in product quality and consistency, promotion of innovation, and advantages in risk management. Traditional financial (TradFi) market infrastructures often successfully employ a vertically integrated model.

However, it's crucial to effectively manage conflicts of interest when operating within such a model. Vertically integrated exchange groups address these conflicts through various means, including functional separation, ethical walls or information barriers, established policies and procedures, independent oversight, disclosure and transparency, as well as education and compliance with regulations. These strategies aim to mitigate conflicts of interest, maintain transparency, and safeguard the interests of stakeholders like investors and market participants.

Secondly, custody. As IOSCO notes, several of the market intermediaries in the DeFi space could be undertaking custody activities. Without proper regulation or even standards, there is a risk that end users could lose their assets.

Finally, we would note that investor education remains of paramount importance. IOSCO has been a global leader in pushing for further investor education and it should continue to do so more broadly but also in particular for these markets. As IOSCO notes, the extent of de-centralisation is often not clear and we fear that retail investors could be misled by the term.

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.

IOSCO effectively delineates the products, services, arrangements, and activities associated with DeFi entities. This undertaking presents a considerable challenge, owing to existing data gaps and the absence of a universally accepted definition of DeFi. Moreover, ascertaining whether an entity qualifies as DeFi is rarely a straightforward binary determination. Additionally, the term 'de-centralised' introduces confusion, as a central platform facilitating interactions between buyers and sellers can fall within the realms of TradFi, CeFi, or Decentralized Finance DeFi.

Notwithstanding, IOSCO's description of DeFi as "financial products, services, arrangements, and activities that leverage distributed ledger or blockchain technologies (DLT), including self-executing code referred to as smart contracts," appears to be excessively broad and susceptible to varying interpretations. It could arguably encompass entities that do not truly conform to the DeFi paradigm. We acknowledge the inherent complexity in achieving a consensus on the definition of DeFi among 238 members. Nevertheless, we propose that establishing guiding principles or offering clarifications, particularly concerning the absence of centralisation and/or intermediaries, may yield valuable benefits.

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

As the WFE, we take governance of regulated exchanges very seriously. Governance which ensures fair, transparent and orderly markets is important for exchanges, market participants, listed companies, listed instruments and broader society. Governance is key to exchanges maintaining trust in products listed on or traded on their exchange.

As such, we have concerns about the accumulation of governance tokens within DeFi platforms. Concentration can lead to decision-making that may not align with the best interests of either the protocol itself or the broader community. This is particularly concerning if token holders have pseudonymity, conflicting agendas or are involved in dishonest activities. These factors can erode trust and compromise investor confidence across the entire blockchain landscape. Additionally, we've learned from the conventional financial sector that decentralised governance models can often be less efficient.

These issues are not merely academic. For instance, Ethereum's recent transition from a proof-of-work to a proof-of-stake model was primarily orchestrated by a centralised team within the Ethereum Foundation. The Merge, has cut Ethereum's energy consumption by 99%. However, it also exemplifies how a centralised group can exert control over a supposedly decentralised blockchain platform. Such realities have led global standard-setting bodies like the Bank for International Settlements to describe decentralisation as an "illusion."

It is imperative that decentralised governance within the DeFi space adheres to best practices and standards. This is essential not only for investor protection but also for establishing and sustaining trust in the entire blockchain ecosystem.

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?

The paper could benefit from additional exploration in two key areas: the limitations of decentralised governance and the varying expertise levels of governance token holders. First, regarding the limitations of decentralised governance: the more parties involved, the longer and more cumbersome the decision-making process becomes. This can be particularly challenging during times of financial instability. Additionally, when decision-making power is so dispersed, accountability becomes difficult to establish and maintain.

Second, the lack of expertise among governance token holders poses another issue. In traditional finance, those in decision-making roles usually have demonstrated a certain level of expertise and often need to pass a 'fit and proper' test. In contrast, holding a governance token doesn't require any specialised knowledge or even an understanding of the issues at hand. Unlike conventional shareholder voting, governance token votes can be cast on routine business matters. Although FTX is not considered a decentralised entity, the recent crisis it faced serves as a glaring example of the perils associated with inadequate governance structures.

One significant weak point in the DeFi landscape is the risk associated with smart contracts. If these contracts are not thoroughly audited, tested, or secured, they may harbour flaws that could be exploited by malicious actors. Should such an attack happen, it could lead to the loss of assets stored in the affected contract.

Another area of concern is the potential for liquidity and price disruptions. Decentralised exchanges (DEXs) within the DeFi environment rely on automated market makers (AMMs) that enable peer-to-peer asset trading without the need for middlemen. However, these AMMs are susceptible to flash loan attacks, where a bad actor could borrow substantial assets from the DEX and manipulate market conditions to trigger a sudden price change.

Moreover, if a hacking or exploitation event takes place, the digital assets stored in the smart contracts or on the DEX could be misappropriated, resulting in heavy losses for asset owners. Additionally, if the DeFi ecosystem were to face a liquidity crunch, it could erode the value of crypto assets, subsequently affecting the overall worth of portfolios managed by custodians.

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?

Yes. Applying the IOSCO standards to DeFi activities is consistent with the goal of achieving the same regulatory outcomes for DeFi as there is in TradFi.