

IOSCO Consultation Report: Policy Recommendations for Decentralized Finance

- Key Takeaways -

GDF submitted a response to the IOSCO Consultation Report: Policy Recommendations for Decentralized Finance (DeFi). GDF's response to this consultation report looks to provide suggestions of areas where further precision may be needed in order for IOSCO member jurisdictions to successfully implement the nine recommendations. GDF has worked with its members to provide a constructive assessment of how to overcome challenges in implementing the recommendations, along 4 key principles:

1. **The Importance of Clear Definitions**
2. **Support for an Appropriate Principles Based Approach**
3. **The Criticality of Risk Weighting**
4. **Best Practices for Intermediaries**

This document outlines the key takeaways from these 4 principle domains, condensing the key considerations detailed in each of these principles for readers' ease of reference.

1. The Importance of Clear Definitions

Key Takeaways

- **Our Proposed Definitions:**

A **DeFi Arrangement** is a distinct financial product or service built on or interfacing with a DeFi Protocol, facilitated through technology infrastructure designed to enable end-users or investors to engage in financial transactions communicated or recorded through the DeFi Protocol.

A **Decentralised Protocol** (DeFi Protocol) is a Credibly Neutral Decentralised Network on top of which financial products and services are created. This is further expanded in Annex 1.

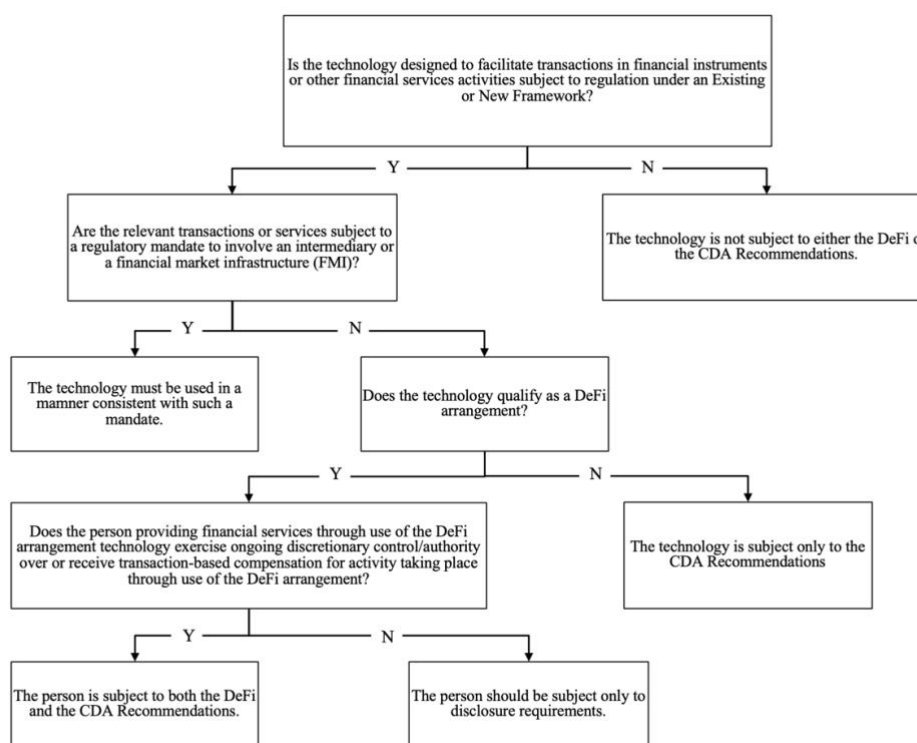
- **Credibly Neutral:** A verifiable and transparent system that aligns incentives with its users.
 - **Decentralised Network:** A distributed, permissionless, and jurisdiction-neutral infrastructure. Its architecture inherently facilitates user autonomy, value management, and an open-source ecosystem.
- **Why Industry Needs Clearer Definitions:** Foundational definitions are critical in enhancing market integrity and investor protection in global digital finance markets. Inconsistent definitions may lead to regulatory challenges and uncertainty for market participants, potentially hindering innovation and efficiency.

- The Risks of Uncertainty:** The lack of clear definitions may discourage market participants from adopting beneficial technology, such as distributed ledger technology (DLT). This uncertainty has influenced regulated firms to be cautious about using DLT more widely, impacting innovation and efficiency in the market.
- Proposed Definitions and Regulatory Approach:** In its response, GDF proposes definitions that are intentionally narrow. They distinguish DeFi Protocols from DeFi Arrangements. In cases where a DeFi Arrangement claims to be "DeFi" but is centralized and provides regulated financial services, it should be subject to appropriate regulatory treatment. The degree of decentralization exists on a continuum, with full centralization subject to existing recommendations. The aim is to clearly delineate DeFi Protocols from DeFi Arrangements and apply regulatory frameworks as needed based on the products, services, or activities of businesses or projects interfacing with them.

2. Support for an Appropriate Principles Based Approach

Key Takeaways

- Support for Principles-Based and Outcomes-Focused Regulatory Framework:** This approach allows for flexibility to address the diverse nature of crypto-assets, considering their differences in technology, utility, and risk profiles. Principles-based regulations avoid rigid rules, allowing regulators to adapt to the dynamic and evolving crypto landscape.
- Cross-Border Consistency and Parameters for Principles:** Cross-border consistency is critical to prevent unintended regulatory arbitrage and to support innovation, investor protection, market integrity, and fair practices. Additional parameters in IOSCO's end-of-year report on DeFi to further substantiate the principles and address the complexities of the rapidly evolving digital finance landscape could support in this respect. To support IOSCO in addressing their implementation we have proposed a flowchart on how the CDA and DeFi recommendations should apply:



3. The Criticality of Risk Weighting

Key Takeaways

- **Technology-Neutral Approach and 'Same Activity, Same Risk, Same Regulatory Outcome':** These concepts are typically associated with centralized control and operations in Traditional Finance (TradFi), and can and should be appropriately applied to all regulated financial products and services, regardless of whether they are created on DeFi Arrangements.
- **Challenges of Equivalence in Risk:** The principle of "same activity, same risk, same regulatory outcome" assumes an equivalence of risk across activities considered the same. However, in the case of DeFi and digital assets, this may not account for the differences in how DeFi products and services are delivered compared to centralized TradFi entities. These differences encompass governance, novel technologies (smart contracts, decentralized Protocols, etc.), and new products and services (aggregators, liquid staking). Therefore, there should be an appropriate risk weighting and assessing where the true risk lies, including novel risks not present in TradFi.
- **Emphasis on Defining Regulation Targets:** Clarity on who or what IOSCO intends to regulate when addressing specific risks arising from the use of DeFi Protocols would help regulators in understanding the regulatory scope and targets within the DeFi space.

4. Best Practices for Intermediaries

Key Takeaways

- **Regulation of DeFi Intermediaries and Responsible Persons:** Regulation of intermediaries and "Responsible Persons" offering regulated financial services or centralized digital asset activities is critical to the sustainable development of the DeFi ecosystem.
- **Caution on Regulating Non-Intermediaries:** We do not support the regulation of non-intermediaries like personal wallets, miners/validators, API providers, block explorers, software providers, and DeFi Protocols themselves.
- **Caution on Intermediation Requirements:** Imposing requirements on the development, maintenance, or use of DeFi technology infrastructures that would require the involvement of intermediaries requires caution. We encourage as leveraging DeFi technology and third-party RegTech solutions could consist in alternatives methods of supervision and enforcement.
- **Focus on Regulated Entity Approach:** Recommendations should primarily focus on defining how regulated entities should interact with DeFi Protocols rather than directly regulating the DeFi Protocols themselves. Additional recommendations could include the adoption of Protocol-level due diligence and disclosures to customers accessing or being exposed to decentralized Protocols.
- **Fostering Common Standards for Intermediaries:** GDF recommends that IOSCO, in collaboration with market participants, should promote the development of common standards for centralized intermediaries and DeFi Arrangements to address operational and market integrity threats and enhance retail customer protection.