

DeFi & Stablecoins Regulatory Overview



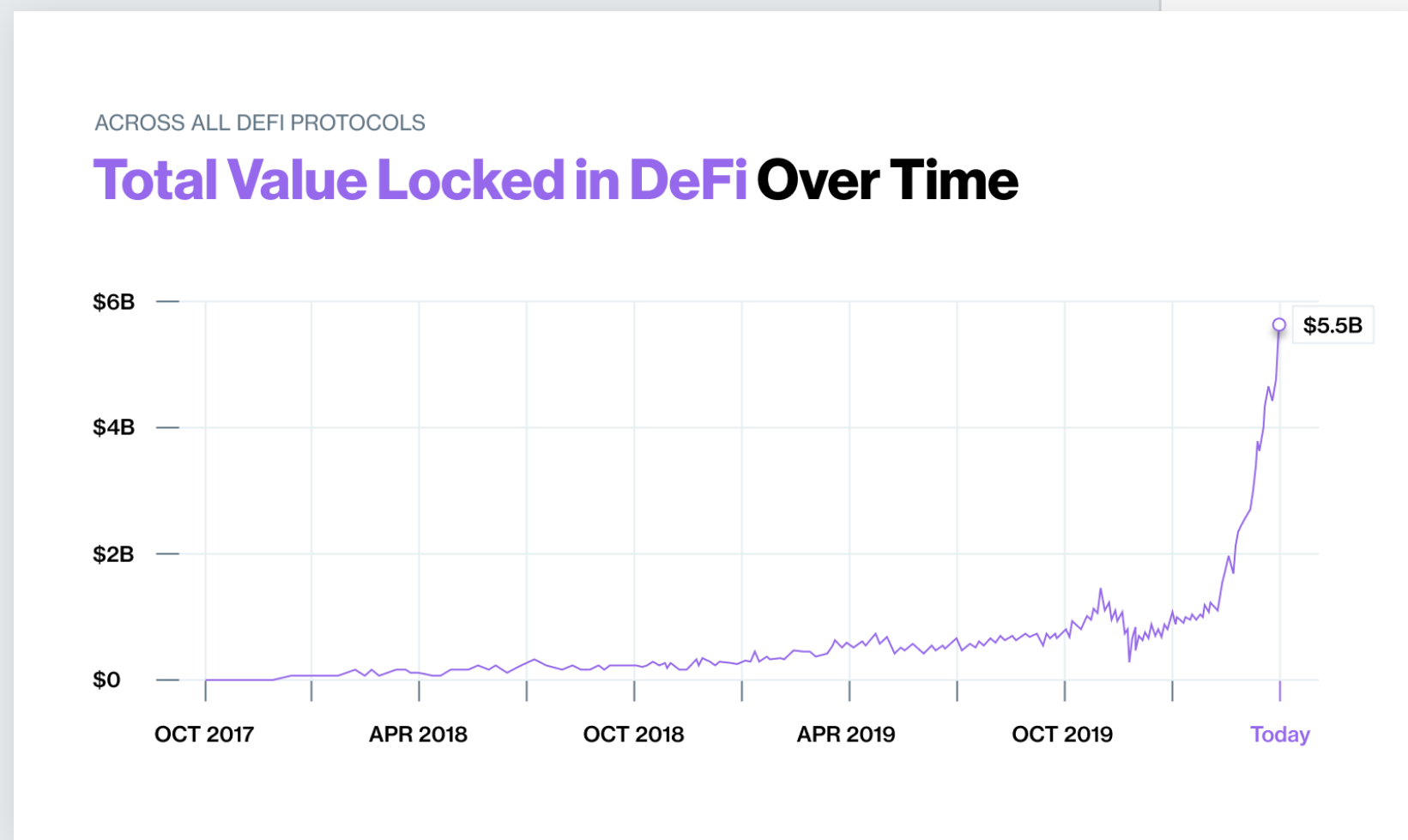
About Me

- Lawyer (but not yours); The George Washington University BA 2010, JD 2013
- Compliance and Investigations @ Baker McKenzie LLP
- Government Enforcement Defense @ Kobre & Kim LLP
- General Counsel @ Compound Labs, Inc.
- DeFi Working Group Chair @ Blockchain Association
- Strategic Advisor @ Variant Fund

Decentralized Finance

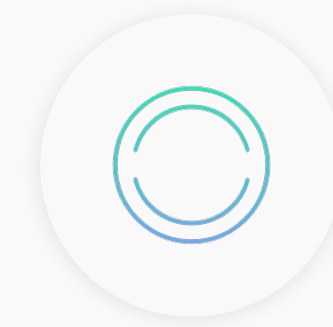
The ultimate vision for decentralized finance (“DeFi”) is a programmable financial system allowing users to engage in a broad range of economic activities without the need to rely on trusted third parties.

Types of DeFi Protocols



Source: [Defi Pulse](#) Date: Aug 2020

\$36.18B as of Feb 26 2021



USD Coin

DAI

Stablecoin Protocols

Produce assets that track the value of the U.S. dollar.



0x protocol

UNISWAP

Exchange Protocols

Let users engage in peer-to-peer trading of assets.



opyn

Nexus Mutual

Risk Mitigation Protocols

Insure and protect against market and technical risk.



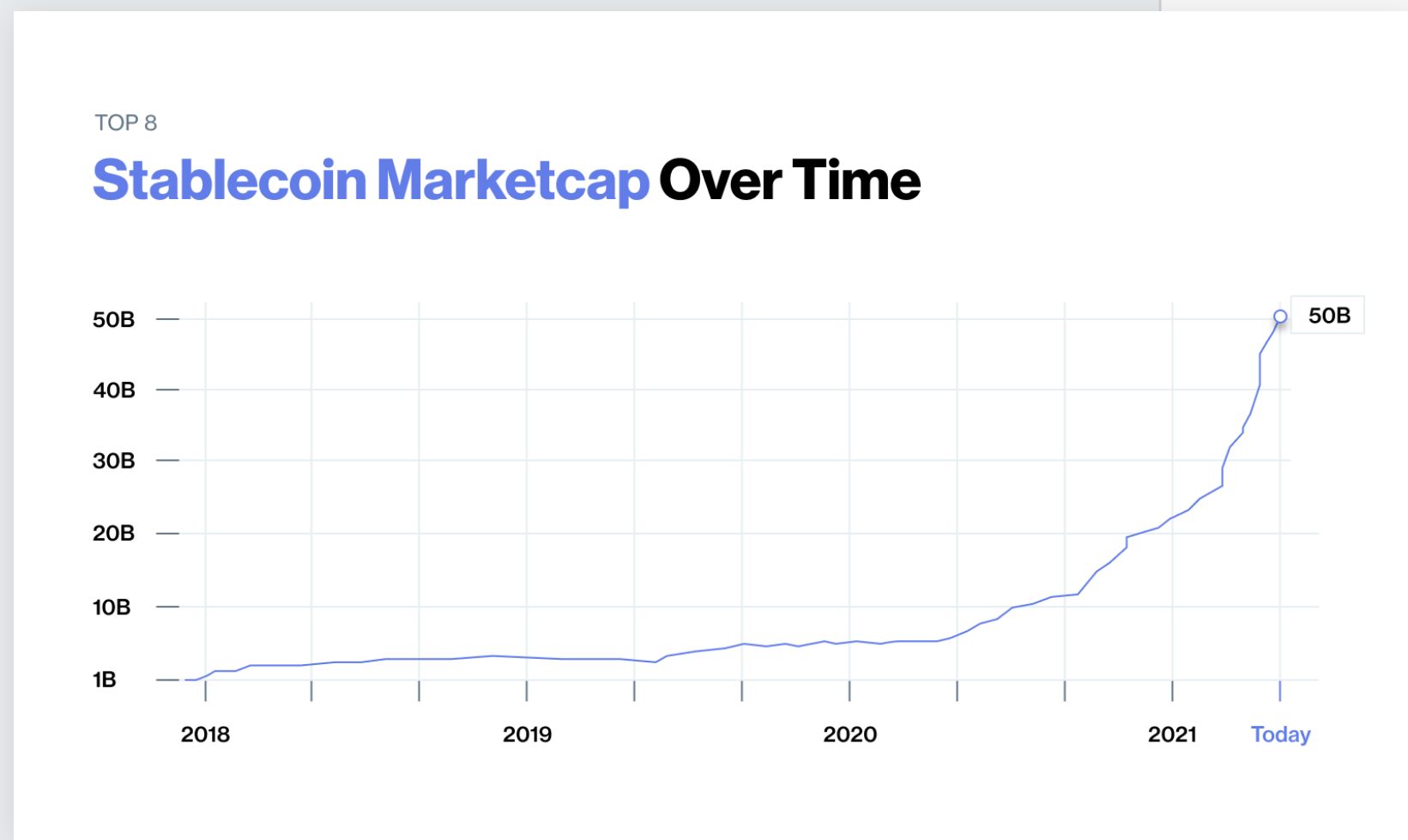
Compound

MAKER

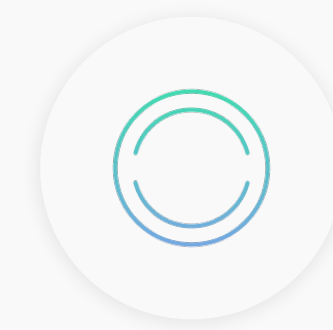
Interest Rate Protocols

Allow users to earn interest on their assets.

Types of Stablecoins



Source: [Messari](#) Date: Feb 2021



USD Coin
 tether

Fiat-Backed

Token represents a claim on fiat currency held in a bank account, while stability depends on transparency and faith in redeem-ability.



Compound Cash
 DAI

Crypto-Backed

Token represents a claim on digital assets held in a smart contract, while stability depends on overcollateralization and efficient liquidation.



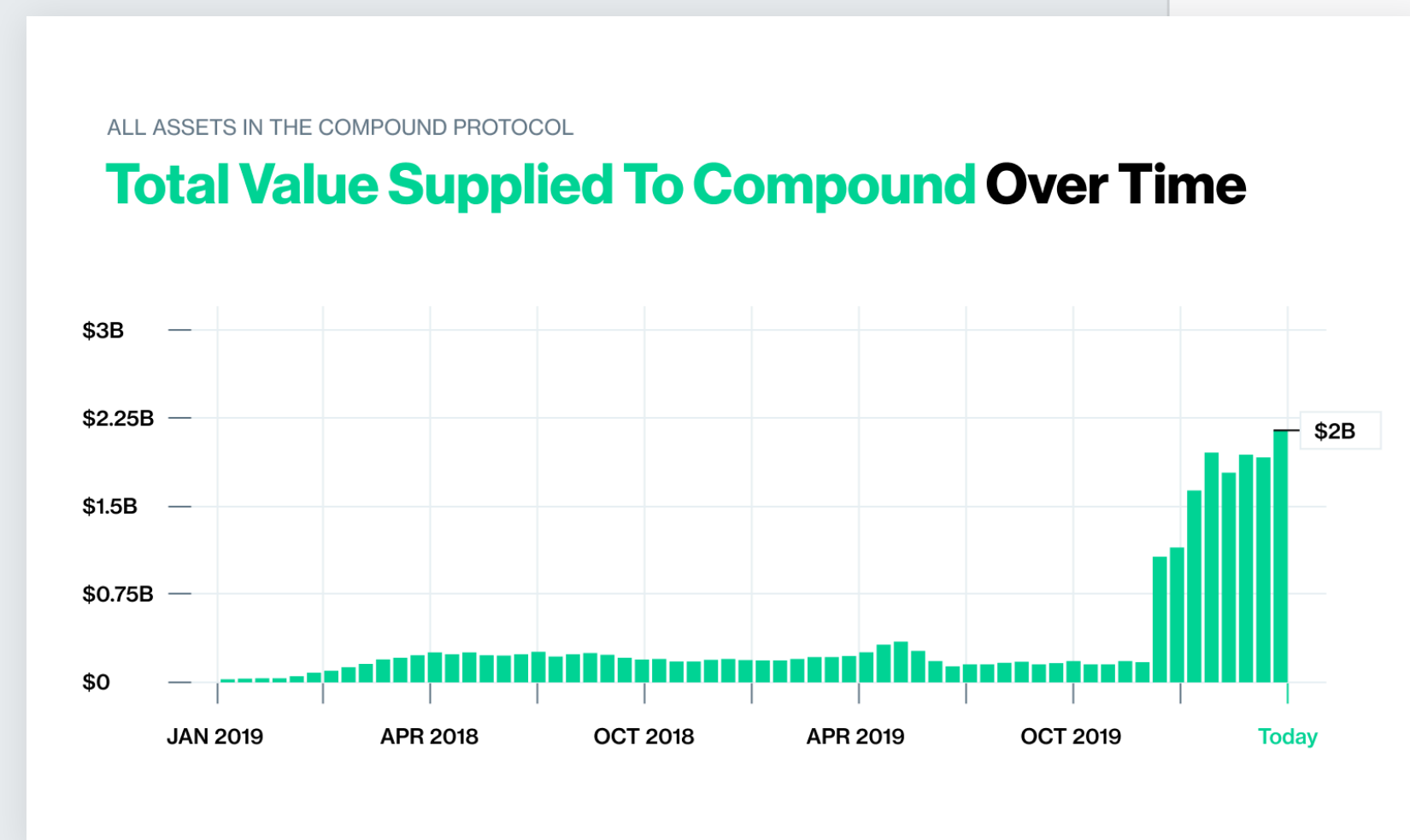
empty set dollar

Algorithmic/Unbacked

Token uses game-theoretic mechanics to influence market participants, while stability depends on the efficacy of incentives, but questionable thus far.

Compound: An Interest Rate Protocol

- The Compound protocol is **a set of globally accessible, open-source interest rates markets** for Ethereum-based assets.
- Anyone who holds digital assets can **safely and freely earn an interest rate on their idle assets** and use them as collateral to borrow other assets.
- The protocol was created and launched by Compound Labs, Inc., but **now lives as a decentralized protocol owned and governed by its users**, just as Bitcoin and Ethereum have no central governing authority.
- The protocol consists entirely of a set of rules and procedures that self-execute on the Ethereum blockchain and cannot be influenced by human opinion or bias.

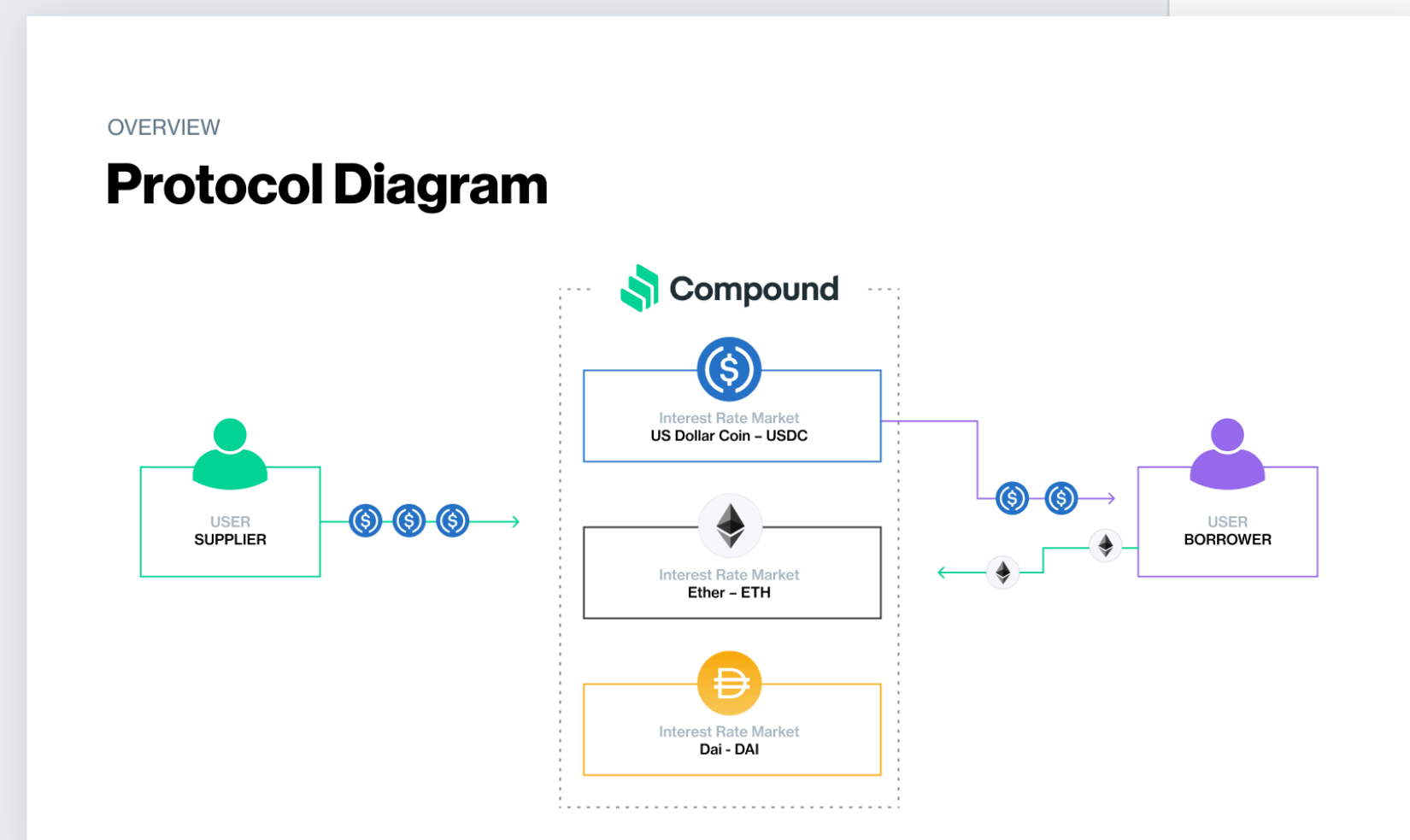


Source: [Dune Analytics](#) Date: Aug 2020

\$8.5B as of Feb 26 2021

How the Compound Protocol Works

- Users can **supply assets to the protocol to earn interest**. Supplying assets may look and feel somewhat like depositing money into a bank account, except that there's no third party with custody over those assets. Users maintain exclusive control at all times and can freely move funds.
- Users can **use their supplied assets as collateral to borrow other assets** from the protocol up to a certain limit. The limit is always less in U.S. dollar value than the amount of collateral that they supplied. In this way, all borrowing positions in the protocol are “overcollateralized.”
- If market conditions change so that a user's borrowing position exceeds their limit—such as if the value of their collateral falls, or the value of their borrowed assets rises—**their position can be liquidated**. Liquidation occurs when a third party repays a portion of the user's borrowed assets and takes the user's collateral as a reward at a discount.
- The combination of overcollateralization and liquidation prevent a situation where users can't recover their supplied assets because other users borrowed them and failed to pay them back.



The Open-Source Future of Finance

DeFi Protocols:

- Are **more efficient** by removing intermediaries and operating 24/7/365
- **Encourage competition and innovation** by attracting thousands of developers
- Give **users more flexibility** by reducing switching costs and eliminating lock-in
- Are **more secure** due to their transparency and battle-testing in a live environment
- Are **more resilient** because they don't rely on trusted parties or single points of failure
- **Protect users** by mitigating counterparty risk through non-custodial, atomic settlement
- Promote good governance by **aligning incentives among users and governors**
- Allow easier, **more efficient oversight and regulation** through permissionless auditability

The Big 3

Securities Laws (SEC)



Commodities Laws (CFTC)

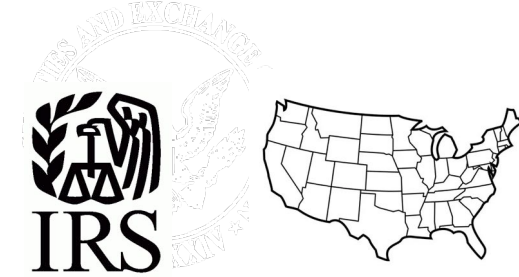


AML/CFT Laws (FinCEN, OFAC)



The Long Tail

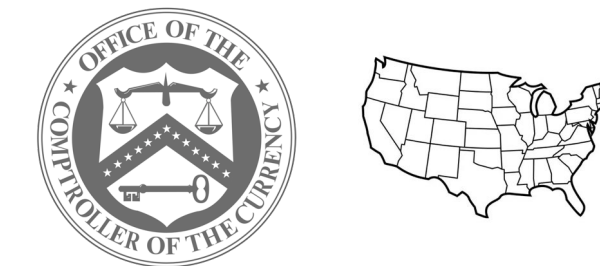
Tax Laws (IRS, States)



Consumer Protection Laws (FTC, CFPB, States)



Banking Laws (OCC, States)



Lending Laws (States)



Money Transmission Laws (States)



Unique Statutes and More (NY Bitlicense, WY SPDI, etc.)



Securities Laws



Securities and Exchange Commission ("SEC")

- The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation
- The federal securities laws originated in the 1930s after the Depression, believed to have been due to financial abuse and information asymmetry
- The SEC regulates "securities" and all securities market participants, including issuers, exchanges, advisers, brokers, dealers, investment companies, etc.

So What?

- Securities are subject to onerous regulatory requirements inconsistent with crypto; they must be registered with the SEC (think IPO), can only trade on SEC-regulated venues, held by SEC-approved custodians, etc.
- Because a securities designation is a death blow to most digital assets, a lot of time (and money) is spent on avoiding SEC regulation

Securities Laws



Investment Contracts and the *Howey* Test

- Many types of securities: stocks, bonds, notes, investment contracts, etc.
- *SEC v. W.J. Howey Co.* (1948) definition of investment contract:
 - (1) an investment of money
 - (2) in a common enterprise
 - (3) with a reasonable expectation of profit
 - (4) based on the efforts of an issuer or promoter

Guidance and Cases

- Bill Hinman (July 2018): Bitcoin and Ether are "sufficiently decentralized"
- Framework for Investment Contract Analysis (April 2019)
- Major contested enforcement actions filed by the SEC:
 - SEC v. Telegram Group (SDNY Mar. 2020)
 - SEC v. Kik Interactive (SDNY Sept. 2020)
 - SEC v. Ripple Labs (filed SDNY Dec. 2020, pending)

Securities Laws



DeFi:

- Governance tokens and “investment contract” analysis
- Synthetic equities and “security-based swap” analysis
- DEX protocols and “national securities exchange” analysis
- Fund management protocols and “investment company” analysis

Stablecoins:

- Single-asset-backed stablecoins and “note” analysis
- Other asset-backed stablecoins and “investment company” analysis

Commodities Laws



Commodity Futures Trading Commission ("CFTC")

- The CFTC's mission is to promote the integrity, resilience, and vibrancy of the US derivatives markets: futures, options, swaps, etc.
- Created in 1974 when the majority of futures trading occurred in agricultural markets; still under the jurisdiction of the House and Senate Ag Committees
- Role and responsibilities greatly expanded after the Global Financial Crisis under the Dodd-Frank Act of 2010, due to the impact of complex financial derivatives

CFTC vs. SEC "Turf War"

- Like securities and the SEC, derivatives must be registered with the CFTC
- Are digital assets securities (SEC) or commodities (CFTC)?
- CFTC generally viewed as more "pro-crypto" than SEC

Commodities Laws



DeFi:

- Derivative trading — DEX protocols enabling margin or leverage
- Derivative tokens — synthetic tokens representing off-chain assets
- Native compliance with CFTC guidance on “actual delivery”
- Native de-risking through liquidation and peer-to-peer transactions

Stablecoins:

- Fiat-backed stablecoins and the definition of a “swap”
- Algorithmic stablecoins and anti-manipulation concerns

AML/CFT Laws



Financial Crimes Enforcement Network ("FinCEN")

- FinCEN enforces the Bank Secrecy Act ("BSA"), our anti-money laundering and countering the financing of terrorism ("AML/CFT") laws
- The BSA requires regulated financial institutions to comply with certain AML compliance program requirements, including "know your customer" ("KYC")
- FinCEN tends to follow the recommendations of an international standard-setting body called the Financial Action Task Force ("FATF")

"Crypto Is For Criminals!"

- Transparency vs. Anonymity/Pseudonymity
- National Security vs. Civil Liberty
- *The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated....*

AML/CFT Laws



DeFi:

- DeFi protocols and platforms as regulated “money services businesses”
- Compliance and liability risks of interacting with pseudonymous liquidity pools
 - AML compliance program recordkeeping, reporting, customer due diligence, etc.
 - Money laundering and sanctions risk based on unknown actors on Ethereum
- FinCEN’s pending proposal for “know your customer’s counterparty” requirements

Stablecoins:

- “Stablecoin arrangements should have the capability to obtain and verify the identity of all transacting parties, including for those using unhosted wallets.”
- *President’s Working Group on Financial Markets, December 23, 2020*

Other Legal & Regulatory Issues

Lending

- “Although the term ‘lending’ is broadly used and easily understood in common parlance, it misrepresents the economic activity that [DeFi] protocols enable. Users of these protocols do not extend credit or incur debt, which are the essential characteristics of a loan transaction. Users earn interest securely through overcollateralization and free market liquidation, not through lending.” - Jake Chervinsky, Bankless, September 2020

Taxation

- Is every DeFi protocol transaction a taxable event, such as supplying assets to Compound?

Unique State Laws

- The New York BitLicense, the Wyoming SPDI, and more

Other Legal Issues, Regulatory Frameworks, and Unknown Unknowns...

Thank you. Questions?

Jake Chervinsky

@jchervinsky

jake@variant.fund