

Bridging Policy and Practice: A Pragmatic Approach to Decentralized Finance, Risk, and Regulation

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ABSTRACT

Confronted with a Hobson's choice of either implementing stringent enforcement or geo-fencing the United States, it's become paramount for regulators and stakeholders to consider collaborative alternatives for shaping the future of decentralized finance (DeFi). Championing this collaboration, this paper emphasizes the need for all DeFi stakeholders, from intermediaries to builders, to proactively enhance transparency and risk management, irrespective of regulatory dictates.

Originating from the adoption of the United States' securities law framework in the 1930's, the evolution of the SEC's regulation of financial intermediation and disruptive technologies is explored. The 2008 financial crisis marked a shift by both the SEC and CFTC towards prioritizing systemic risk regulation and perceiving disruptive technologies, like automated trading and digital assets, as potential threats. The disconnect between this top-down approach and stakeholder experiences underscores the need for early collaboration to ensure regulations align with technological realities.

In exploring DeFi, this paper underscores the importance of stakeholder initiatives aimed at bolstering transparency and risk management. It challenges the "same risk, same rules" paradigm applied to DeFi, advocating instead for enhanced collaborative initiatives, such as public-private partnerships. Such an approach fosters actionable risk mitigation practices and resilience.

This paper delves into innovative AML identity verification and risk processes for DeFi. It then evaluates potential adaptations of certain SEC and CFTC rules and guidance to the use of DeFi services. This adaptation should involve an open collaborative process to improve diligence, risk management, and pre-transaction, smart contract encoded controls.

When implemented collaboratively, these solutions can enhance outcomes for both regulators and stakeholders, striking a balance between regulatory objectives, risk management, and innovation. This balance can reduce the need for stringent enforcement and lessen dependence on top-down systemic risk-based regulation.