Bridging Policy and Practice:

A Pragmatic Approach to Decentralized Finance, Risk, and Regulation

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Eric W. Hess

ABSTRACT

*Confronted with a Hobson's choice of either implementing stringent enforcement or geo-fencing the U.S., it's become more critical for regulators and stakeholders to actively consider viable paths for active collaboration to shape the future of decentralized finance (DeFi). Championing and fostering such collaboration is crucial to this endeavor. To that end, this paper analyzes the evolution of the SEC's and CFTC's regulation of financial intermediation and disruptive technologies.*

*It begins by highlighting the post-2008 financial crisis shift towards prioritizing systemic risk regulation and perceiving disruptive technologies, such as automated trading and digital assets, as potential threats to financial stability. The paper further explores the disconnects between this top-down approach and the realities faced by market participants, asserting the necessity for early stakeholder collaboration to ensure that regulation is adequately informed by the operation, capabilities, and risks of the underlying technology.*

*Next, in exploring DeFi, the paper underscores the importance of DeFi stakeholder initiatives aimed at bolstering transparency, compliance, security, and risk management in ways that allow the technology to flourish. It advocates for the enhancement of these initiatives through collaborative efforts, such as public-private partnerships with the SEC and CFTC, to foster actionable risk mitigation practices and resiliency.*

*Moreover, the paper evaluates how existing SEC and CFTC rules and guidance could be adapted to DeFi services. This adaptation could be facilitated through an open collaborative process between stakeholders and regulators to improve diligence, risk management, and monitoring, as well as pre-transaction, smart contract encoded controls. The paper also examines innovative solutions like privacy-enhancing technologies, verified credentials, verified AML processes for DeFi, and artificial intelligence.*

*These pragmatic solutions can serve both market participants and regulators’ objectives if pursued in a non-adversarial environment. They can strike a balance between compliance, risk management, and innovation, reducing the reliance on stringent enforcement and top-down systemic risk-based regulation.*