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LeXpунк provides the following comments on IOSCO's Consultation Report on Policy Recommendations for Decentralized Finance (**DeFi**) (the **Report**).

LeXpунк is a community of lawyers and software developers dedicated to providing open-source legal resources and support for the DeFi industry, providing a voice for individuals who wish to collaborate through Decentralized Autonomous Organizations (**DAOs**), and advocating for these communities.

LeXpунк disagrees with the premises of the Report as well as the recommendations that flow from these flawed premises in the Report for the following reasons:

- IOSCO's consultation process has been inadequate on the whole, lacks depth in analysis, and has failed to ensure a broad range of stakeholders have been given an effective opportunity to consider and provide feedback.
- IOSCO's recommendations are based on a number of flawed premises without any serious analysis of the underlying facts, including the flawed premise that DeFi arrangements are not - and cannot - be decentralised.
- IOSCO's recommendations fail to acknowledge, let alone address, the broader implications of the ill-defined concept of "Responsible Persons".
- IOSCO's recommendations are too vague and unclear to be implemented in a globally consistent and fair manner.

**First, IOSCO's consultation process has been inadequate on the whole, lacks depth in analysis and has failed to ensure a broad range of stakeholders have been given an effective opportunity to consider and provide feedback.**

IOSCO announced the consultation on September 7, 2023 and invited comments on or before October 19, 2023. The report seems to eschew researched, factual determinations in favor of predetermined narratives. As commentators to the CDA framework have previously cautioned, we remain wary of the "same activity, same risk and same rules" approach to regulation<sup>1</sup> and certainly applied at a 50,000 foot level of "economic activity" without any serious and granular discussion of the specific mechanics of the activity in question before applying frameworks based on addressing intermediary risk. Given the broad scope of the Report and the far-

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<sup>1</sup> See, e.g., Canadian Web3 Council response, available at <https://web3canada.ca/our-joint-response-with-euci-to-ioscos-consultation-report-for-crypto-and-digital-asset-markets/>.

reaching implications of the recommendations, a mere six-week comment period was not adequate for meaningful consultation.

Further, the Report asserts that there was “broad consultation with IOSCO members, academics and industry”, as well as “additional outreach with academics, data analytics firms, researchers and technologists”.<sup>2</sup> Although Annex G to the Report summarizes information received by a survey of members of IOSCO’s Fintech Task Force, the Report does not disclose even basic information regarding the identities of other stakeholders, how they were selected for directed consultation, and what input they provided. Interestingly, it does not appear that any significant industry stakeholder were selected to participate.

The short public consultation period and the lack of details regarding the earlier directed consultation strongly suggests that the only stakeholders that have been meaningfully consulted are IOSCO’s own members as well as participants that fed into a desired narrative rather than a diverse group of stakeholders engaging in a meaningful deliberative process.

Given the lack of engagement, we would hope that fact-based determinations contained in the Report would have significant citation with appropriately weighty source material (i.e. a peer reviewed study versus a Coindesk article). However, among the Report’s sparingly cited materials are cites to single source blockchain data analytic firm reports, which have been publicly disproven of rendering dispositive data.<sup>3</sup> Many other sections make sweeping statements without meaningful analysis or data. In particular, the section discussing “Key Risks and Considerations” cites risks that would be attendant to any sector before a well tailored policy envelope were developed (i.e. convincingly describes the need for \*some\* policy envelope) and then cherrypicks observations like “[m]ore specifically, DeFi governance structures are often opaque, experimental, unpredictable, and/or easy to manipulate” without addressing meaningfully what specific structures exist, what specific risks exist, and how regulation might work to respect decentralized models while mitigating the identified risks.

**Second, IOSCO’s recommendations are based on a number of flawed premises without any serious analysis of the underlying facts, including the flawed premise that DeFi arrangements are not - and cannot - be decentralised.**

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<sup>2</sup> Report, page 5.

<sup>3</sup>See, e.g. Declaration of Elizabeth A. Bisbee, Director of Investigation Solutions for Chainalysis Government Solutions, a wholly owned subsidiary of Chainalysis Inc., filed 07/18/23, available at <https://www.courtlistener.com/docket/59988850/149/1/united-states-v-sterlingov/> (“Historically, Chainalysis has not gathered and recorded in a central location false positives /false negatives because there is design to be more conservative in the clustering of addresses. In response to the Court’s inquiry, Chainalysis is looking into the potential of trying to collect and record any potential false positives and margin of error, but such a collection does not currently exist.”); see also (citing that Bisbee also testified that she was “unaware” of scientific evidence for the accuracy of Chainalysis’ Reactor software used by law enforcement” in an unreleased transcript of a June 23 hearing shared with CoinDesk.”).

LeXpunk notes the following statement by the Chair of IOSCO's Board-Level Fintech Task Force in the press release announcing the consultation:

There is a common misconception that DeFi is truly decentralised and governed by autonomous code or smart contracts. In reality, regardless of the operating model of the DeFi arrangement, "responsible persons" can be identified. Our recommendations are therefore predicated on the need to identify these persons, whether legal or natural, who should bear responsibility for upholding investor protection and market integrity.<sup>4</sup>

These assertions are framed in absolute terms. They reject even the possibility that DeFi systems could be "truly decentralised and governed by autonomous code or smart contracts". Indeed, the fact that DeFi systems are truly decentralised and governed by autonomous code or smart contracts is not a "misperception". Although humans are involved in creating and deploying a DeFi system, once deployed, users interact with one another directly. There is no person or entity in the middle, only a system of smart contracts, and imposing burdensome regulatory obligations on mere developers of code and categorizing them as "Responsible Persons" carries important policy considerations not addressed by the Report.

For this reason alone, the recommendations are unsound because they are (in the Chair's own words) "predicated" on factual assertions that is subject to disproof, particularly given the rapid evolution of DeFi systems and protocols. Instead of level setting with a definition of DeFi so that regulators are able to deal with DeFi on its merits, the Report instead never seriously engages in this necessary exercise. Instead, flitting about to reference varying degrees of poor market practice that are in need of improvement. It may be more productive to propose a definition of DeFi to orient substantive discussion than the tactics that were chosen. In our view, to the extent that systems do not (largely) meet this definition, they should not be considered DeFi for purposes of a policy discussion aimed at providing a workable framework that mitigates risk. This is a level-setting intended to push past any discussion around whether these systems are actually centralized (as discussed in depth in the Report). For purposes of our discussion, the term "decentralised finance system" means any runtime software that:

A. is primarily designed to enable general-purpose, peer-to-peer, peer-to-system or system-to-system trading, borrowing, lending, or representation in tokenised form of, digital assets, in each case:

- a. in accordance with rules, algorithms or protocols; and
- b. in a manner not requiring reliance on any custodial intermediary;

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<sup>4</sup> <https://www.iosco.org/news/pdf/IOSCONEWS706.pdf>

B. is stored and executable on a read-unpermissioned, blockchain-based virtual machine environment governed by a peer-to-peer network of nodes running a single deterministic state transition byzantine-fault-tolerant consensus protocol; and

C. is not owned, controlled, permissioned, or arbitrarily modifiable by any single person or group of persons known to one another who have entered into an extrinsic agreement to act in concert with respect thereto.

We want to highlight that in this response we *\*should be\** focussing exclusively on, and discussing the technical features of and potential regulatory approaches to, open, permissionless blockchain networks. That is, blockchain networks that anyone can view and access, in which anyone can participate, and where all components and infrastructure are made available on an open source basis (without requiring any permission, authorisation, identification or credentialing of any kind). There are blockchain networks that operate on a closed, permissioned basis where one or more centralised administrators control access and use of the network (in various respects). We should not consider these types of permissioned networks in our analysis here.

In a world where regulators have neither grappled with the benefits of disintermediation nor put effort into policy frameworks that incentivize decentralization as a characteristic worthy of preserving, we think it premature to build policy determinations around a mental model that ‘true decentralization’ has not, and thus cannot occur while imposing frameworks of mandatory intermediation to further ensure that it never happens. We view the report as attempting to label the entire model itself as representative of varying industry bad practices that may present themselves without doing the work of separating out those practices from the definition and seriously considering how best to approach the challenges.

***Third, IOSCO’s recommendations fail to acknowledge, let alone address, the broader implications of the ill-defined concept of “Responsible Persons”.***

The Report suggests that Responsible Persons could include a wide range of persons, including founders and developers of a project, DAOs or participants in DAOs, those with access to material information about the protocol or project to which other participants lack access, and those who are “facilitating” interaction with the protocol.<sup>5</sup>

Whether developers of software implementing DeFi protocols, publishers of information regarding DeFi protocols, persons who merely possess specialized information, and participants in novel organizational forms such as DAOs should be subject to regulatory obligations are profound and complex policy questions raising important considerations beyond market integrity and investor protection. In particular, the potential imposition of such obligations engages fundamental rights such as the rights of freedom of expression and freedom of association. By focusing solely on market integrity and investor protection considerations, IOSCO’s recommendations ignore other important policy considerations and societal values.

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<sup>5</sup> Report, page 24.

***Fourth, IOSCO's recommendations are too vague and unclear to be implemented in a globally consistent and fair manner.***

IOSCO's press release dated September 7, 2023 suggests that the Report's recommendations, together with other recommendations by IOSCO, would provide a "clear, interoperable, and globally consistent policy framework for crypto and digital assets, including DeFi."<sup>6</sup>

As noted above, the Report suggests that "Responsible Persons" could include a wide range of persons, including developers of a DeFi project, holders or voters of governance tokens, DAOs or DAO participants, and those who facilitate access to a protocol.<sup>7</sup> Indeed, the scope of "Responsible Person" is potentially unbounded, as the Report recommends that "[i]n assessing who is a Responsible Person...a regulator should evaluate all the facts and circumstances".<sup>8</sup>

If a "Responsible Person" can only be identified by a regulator's evaluation of "all the facts and circumstances", there will invariably be inconsistency in how "Responsible Persons" are identified, simply because different regulators may evaluate similar facts differently. Further, oversight of regulatory actions will be impossible due to the lack of a meaningful standard by which a regulator's evaluations can be reviewed by courts or other authorities exercising oversight. Finally, it is fundamentally unjust if individuals and businesses have no standard or guidance with which to gauge whether they are, or could be, Responsible Persons subject to potentially significant regulatory obligations and liability for non-compliance.

Far from providing clarity, interoperability and consistency, IOSCO's recommendations, if adopted, would only create uncertainty.

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Whether to extend securities or other financial regulation to persons who develop, fund, use or otherwise interact with DeFi protocols raises a number of considerations besides concerns about market integrity and investor protection. The balancing of these considerations is not a question solely for securities regulators.

LeXpunks urge IOSCO not to finalize any recommendations unless and until it has meaningfully consulted with a broader set of stakeholders and revised its recommendations to acknowledge the need for consideration of a range of policy objectives and societal values when addressing DeFi and to provide more precise standards so that affected persons can reasonably anticipate their obligations and regulatory action can be subject to meaningful review and oversight instead of this attempt to declare a nascent industry per se illegal and kill it in its cradle.

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<sup>6</sup> <https://www.iosco.org/news/pdf/IOSCONEWS706.pdf>

<sup>7</sup> Report, pages 23-24.

<sup>8</sup> Report, page 23.