Preventing illicit finance and regulatory arbitrage through decentralized finance platforms

Background: This approach establishes a clear regulatory framework for decentralized finance platforms by defining accountability, clarifying oversight, and preventing the misuse of decentralized protocols for illicit finance, sanctions evasion, or to bypass market guardrails. This risk-based framework preserves space for sufficiently decentralized protocols while ensuring accountability for controlling parties and U.S.-facing access points.

Summary:

- Treasury, in coordination with SEC, CFTC, and Fed, designates which parties exercise control or influence over a DeFi platform; controlling persons required to comply with requirements applicable to entities performing the functions of the DeFi platform.
- Treasury and financial regulators define when a person/entity exercises "control or sufficient influence."
- Anyone designing, deploying, operating, or profiting from a DeFi front-end that facilitates covered activities (trading, custody, settlement, lending, etc.) is a digital asset intermediary.
- SEC to make rules on how broker requirements apply to front-ends providing access to securities; CFTC to issue parallel rules applying requirements from its broker framework (either FCM or digital commodity broker rules) to front ends providing access to digital commodities or commodity derivatives.
- Treasury determines whether a protocol is sufficiently decentralized. Protocols meeting decentralization criteria are not intermediaries, absent U.S.-facing front-ends or recurring revenues.
- Treasury may place DeFi protocols or front-ends on a Restricted List. Treasury must publish an annual report assessing DeFi-related risks.
- Writing or publishing open-source code is not a violation, absent deployment, control, or profit from the protocol.

Regulatory Authority

(A) Treasury, in coordination with relevant financial regulators such as the SEC, CFTC, and the Fed, shall designate which parties and entities exercise control over a DeFi platform. Persons so designated shall be treated as "digital asset intermediaries" for purposes of this Act and for Bank Secrecy Act and International Emergency Economic Powers Act (50 U.S.C. 1701). Entities identified as exercising such control would be classified as Virtual Asset Service Providers (VASPs) under U.S. law and subject to applicable regulatory requirements. Controlling persons are also required to comply with any other requirements applicable to entities performing the functions of the DeFi platform.

(B) Treasury shall, in consultation with the SEC, CFTC, and Federal Reserve, coordinate with the Financial Action Task Force (FATF), other international standard-setting bodies, and foreign financial regulators to promote consistent global standards for the regulation of DeFi protocols, including efforts to reduce the risks of illicit finance, sanctions evasion, and regulatory arbitrage across jurisdiction.

Rulemaking on Designation Criteria and Effects

(C) Treasury, in consultation with the SEC, CFTC, and Federal Reserve, shall apply standards to define when a party or entity exercises "control or sufficient influence" over a DeFi platform, for purposes of determining if a DeFi platform constitutes a digital asset intermediary. In determining whether an entity or person exercises control or sufficient influence over a DeFi platform, Treasury, in consultation with the SEC, CFTC, and Federal Reserve, shall consider whether the entity or person(s)

1) Maintains an active business relationship with users of the DeFi platform, including through maintenance of front-end applications through which a substantial proportion of users interact with the DeFi platform;
2) Routinely makes operational decisions associated with the underlying DeFi platform, in connection with receipt of financial consideration;
3) Maintains the ability to set or change parameters of the underlying DeFi platform (whether unilaterally or by virtue of exercising rights associated with governance tokens connected to either a front-end application or the underlying DeFi platform);
4) Makes or retains the ability to enter into ongoing business relationships with contractual parties associated with maintenance of the underlying DeFi platform; and/or
5) Retains the ability, directly or indirectly, to shut down the underlying DeFi platform.

Savings Clause: A finding of control or sufficient influence under this subsection does not require proof that the person or entity has unilateral control or custody over users' assets or the protocol

(D) Section (A) shall not apply to individuals or entities that do not exercise meaningful control over a DeFi protocol. Specifically excluded are:
i) Websites or forums that only enable communication between buyers and sellers in peer-to-peer transactions.
ii) Developers or sellers of software applications who do not maintain an ongoing business relationship with users or profit directly from transactions.

iii) Merchants or service providers that accept virtual assets solely as payment for goods or services.
iv) Providers of ancillary products or services to virtual asset networks, such as:
    (1) Hardware or unhosted wallet providers, provided they do not facilitate transactions on behalf of others.
    (2) Network and infrastructure participants (e.g., miners, validators, node operators) that create, validate, or broadcast transactions without controlling protocol operations.
v) Independent developers of open-source code who do not operate or control the protocol and receive no compensation or governance rights associated with such contributions.

Front-End Application

(E) Any person or entity who designs, deploys, controls, operates a front-end service for a DeFi protocol (i.e., a software service that makes available any financial service conducted through a protocol), or materially benefits from a decentralized finance protocol that facilitates covered financial activities (trading, bringing buyers and sellers together, custody, clearing, settlement, lending, or similar) shall be deemed a digital asset intermediary. These persons required to register as brokers with the SEC, or as FCMs or digital commodity broker with the CFTC (unless another category of registrant is more appropriate to their activities).

Rulemaking

(F) The SEC shall issue rules to clarify the application of existing broker requirements to front-end applications facilitating activity through DeFi protocols, including:
    (1) Required disclosures to users regarding risks, fees, and governance;
    (2) Customer protection standards, including safeguarding of assets and transaction transparency;
    (3) Rules on extensions of credit;
    (4) Best execution and Reg NMS rules;
    (5) Code audit & public-availability verification;
    (6) Agency-basis only trading;
    (7) Third-party security reviews & stress testing;
    (8) Change-of-control notifications;
    (9) Policies to address conflicts of interest between operators and users; and
    (10) A phased implementation timeline to allow orderly market adaptation.

ii) The CFTC shall promulgate similar rules over CFTC-regulated entities, either FCMs or digital commodity brokers (depending on spot market bill details).

Determination of Decentralization

(G) Treasury shall have the authority to determine whether a protocol is sufficiently decentralized. In making this determination, Treasury shall consider the factors described in the "control or sufficient influence" rulemaking above.

(1) A protocol determined to be sufficiently decentralized is not deemed a digital asset intermediary by virtue of protocol operation alone, provided no person operates a U.S.-facing front-end or receives recurring revenues from third-party use.

Restricted List Authority

(H) Treasury, in consultation with the SEC, CFTC, and Federal Reserve Board, may designate any DeFi protocol, front-end application or other access point—whether sufficiently decentralized or not—or any class of these entities onto a "Restricted List" if it is determined that the protocol or class or protocols:

(1) Facilitates sanctions evasion, illicit finance, money laundering, or terrorist financing, including entities incorporated, headquartered, or primarily operating in jurisdictions subject to U.S. sanctions, or entities owned or controlled by persons in such jurisdiction; or

(2) May pose, or where a "material share" of activity may reasonably be expected to pose, a risk to fair, orderly, and efficient markets, the stability of the U.S. financial system, or national security, including by making available activities prohibited under the regulatory frameworks applicable to traditional market participants.

ii) Prior to or promptly following designation, Treasury shall provide public notice, an unclassified basis for designation, and an expedited administrative reconsideration process, consistent with the protection of intelligence sources and methods.

iii) U.S. persons and financial institutions subject to U.S. jurisdiction shall be prohibited from transacting with or providing access to entities on the Restricted List, subject to general or specific licenses Treasury may issue, including for wind-down, victim remediation, investigative cooperation, or other activities in the public interest.

iv) Treasury, in consultation with the CFTC, SEC, and Federal Reserve, is required to publish an annual report assessing the national security and financial stability risks of DeFi platforms, including specific risk assessments of any DeFi platform with material transaction volume that qualifies as truly decentralized.

Risk Management Standards for Intermediaries

(I) General Duty. A registered digital asset intermediary that provides customer access to, or routes orders through, a decentralized finance protocol shall establish and maintain a written risk-management program reasonably designed to protect investors and the integrity of the market.

(J) Such program shall include, at a minimum—

(1) review of the protocol's code and associated documentation, including immutability/upgradeability analysis;

(2) confirmation that code is publicly available and subject to independent audit;

(3) developer documentation disclosing all material risks;

(4) plain-language disclosures to customers regarding material risks, including technical, operational, and governance risks;

(5) ongoing monitoring for fraud, manipulation, sanctions evasion, money laundering, or other illicit finance activity;

(6) emergency incident-response mechanisms and proportional controls;

(7) periodic stress testing and third-party security reviews; and

(8) agency-basis trading only, not proprietary principal trading.

(9) The Commission, in consultation with the CFTC and Treasury, shall adopt rules to—

(a) establish minimum standards for risk-management programs under this subsection;

(b) prescribe the form and content of customer disclosures;

(c) require periodic reporting and recordkeeping sufficient to permit supervisory examination and enforcement; and

(d) require notice to the Commission of any change of control affecting a covered intermediary.

Coder Liability

(K) No person is in violation solely for authoring or publishing open-source code, provided such person does not deploy, control, operate a front-end for, or materially benefit from the protocol. This does not limit liability for fraudulent schemes or evasion.

DeFi Money Services Business Standard

(L) For purposes of the BSA and its implementing regulations:

(1) A decentralized finance arrangement shall be considered a money services business when:

person receives recurring revenue from third-party use of the protocol;

(a) that person or affiliated governance holders regularly approve updates or otherwise exercise operational control or sufficient influence; and

(b) either -

(i) initial or current token ownership is highly concentrated, or
(ii) such insiders routinely prevail in governance decisions.

(2) Nothing in the subsection shall limit Treasury's authority under section [ ] of this Act to designate additional digital-asset activities as entities as money services businesses.