

# DeFi & Stablecoins Regulatory Overview

Jake Chervinsky



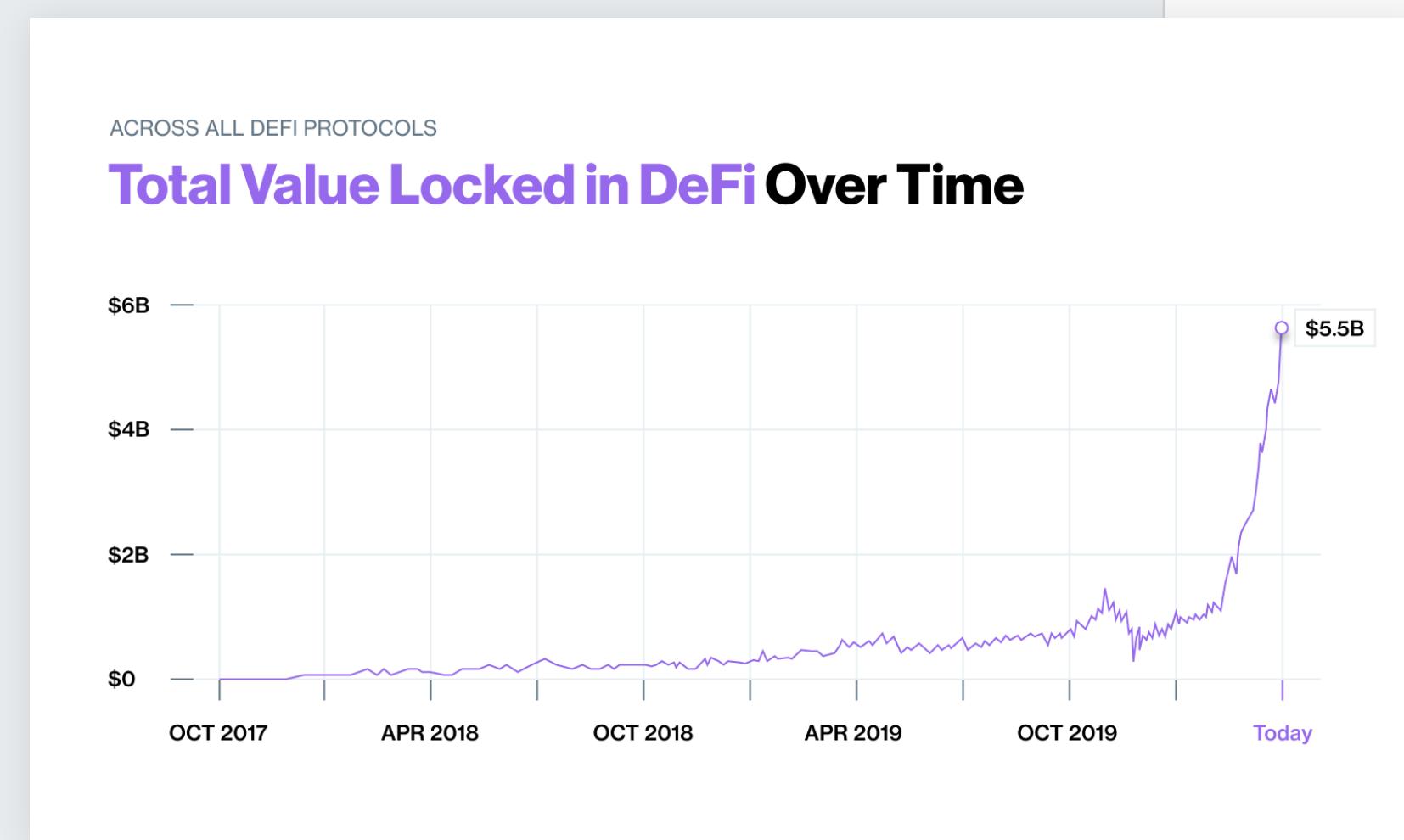
## About Me

- 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

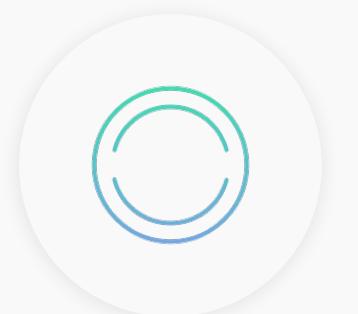
# Decentralized Finance

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



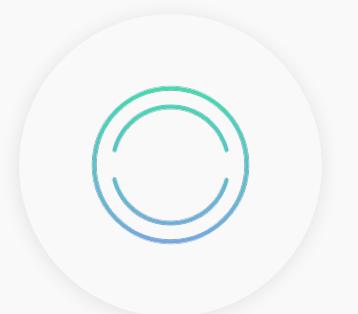
Source: [Defi Pulse](#) Date: Aug 2020  
\$36.18B as of Feb 26 2021



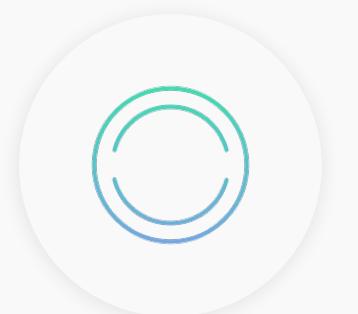
USD Coin  
DAI



opyn  
Nexus Mutual



0x protocol  
UNISWAP



Compound  
MAKER

## Stablecoin Protocols

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

## Exchange Protocols

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

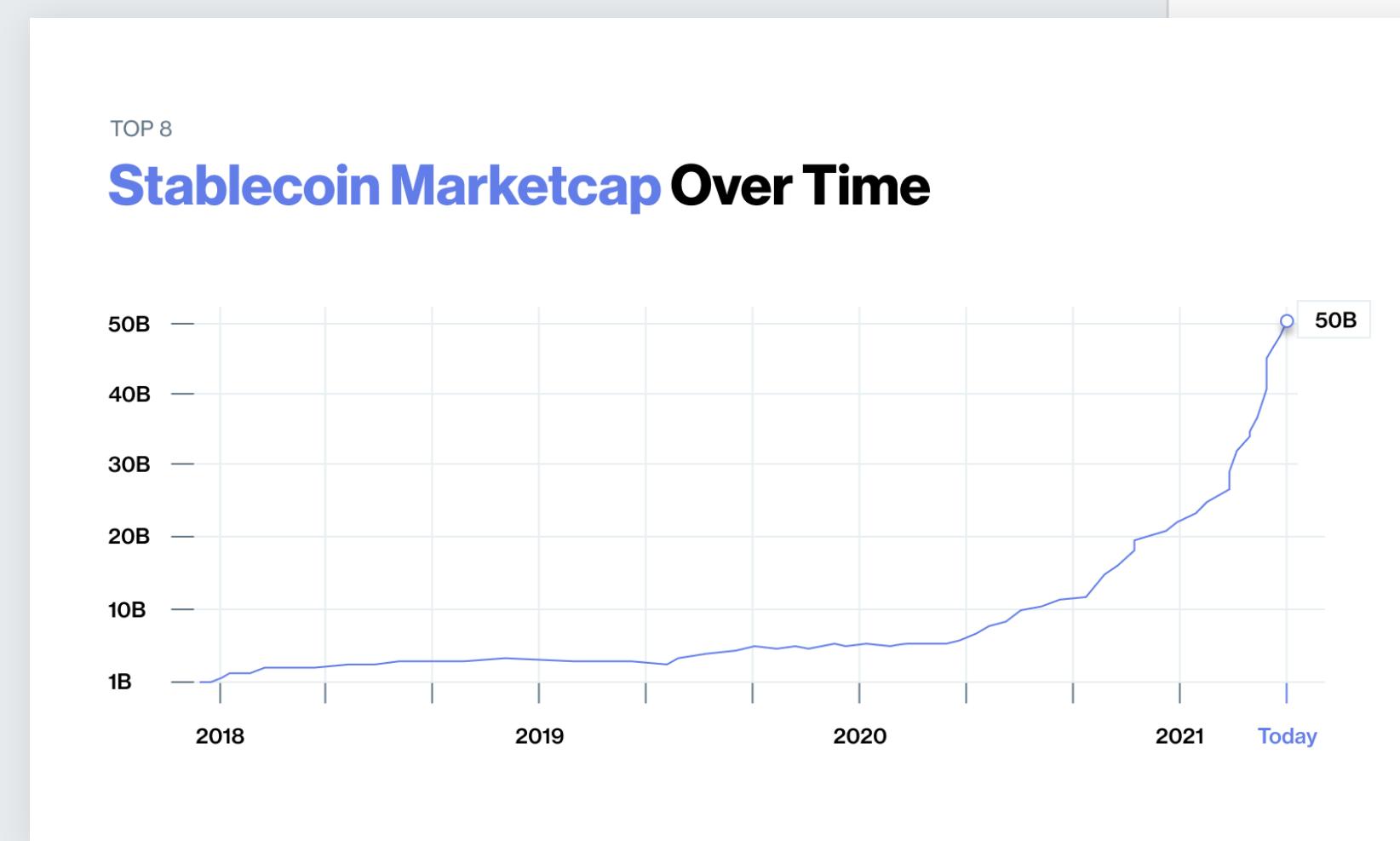
## Risk Mitigation Protocols

Insure and protect against market and technical risk.

## 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.

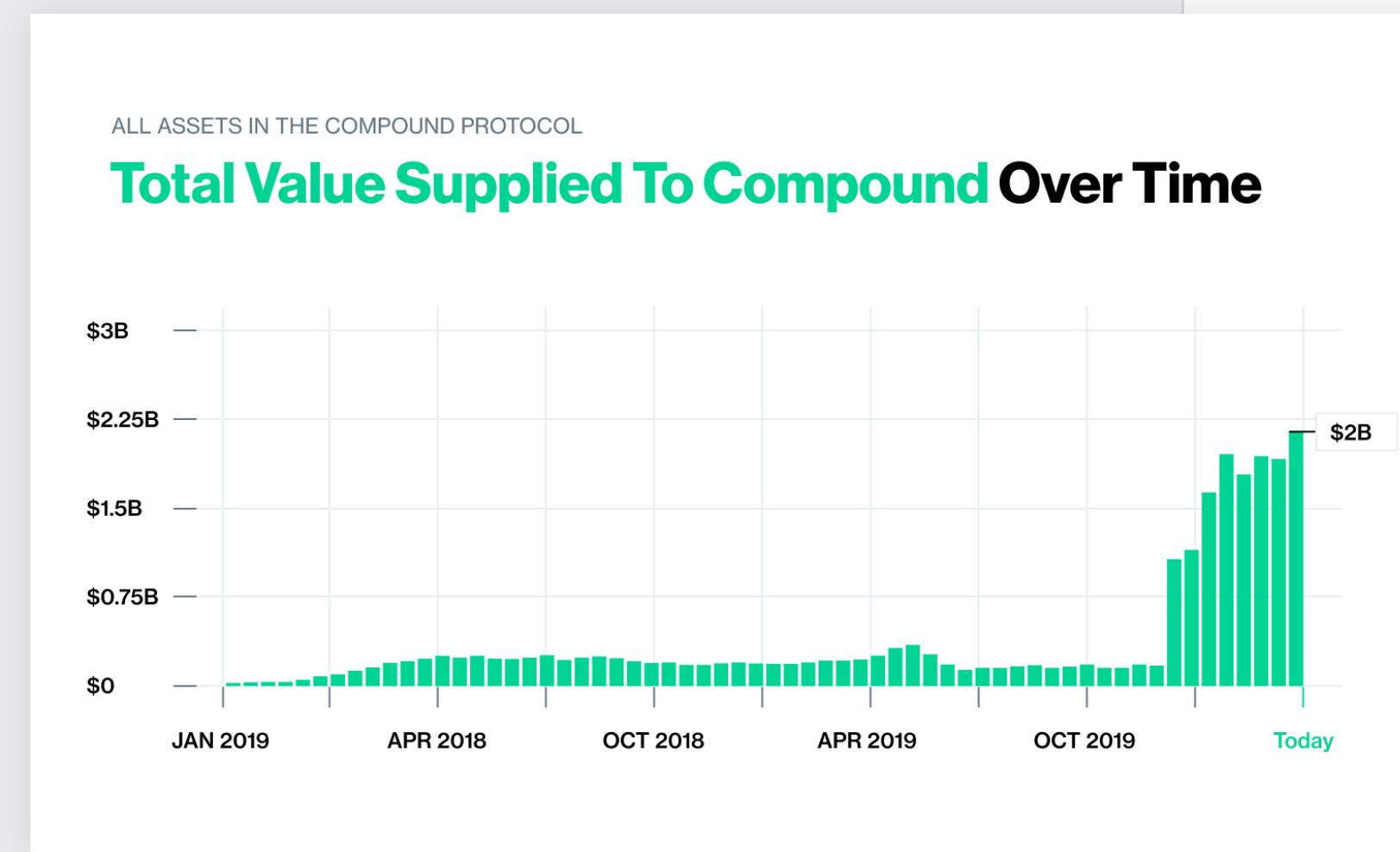


empty set dollar

## 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

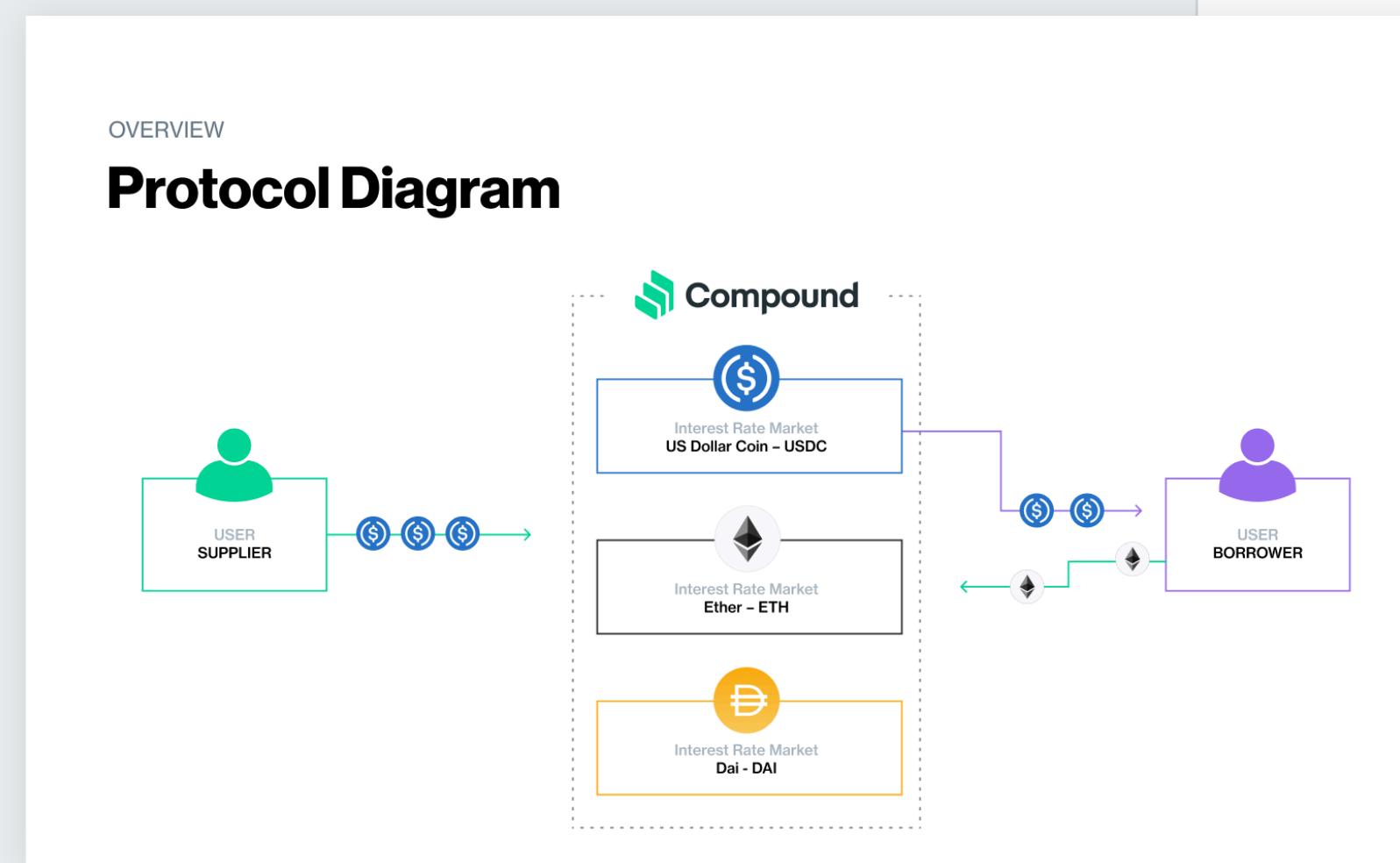


Source: [Dune Analytics](#) Date: Aug 2020

\$8.5B as of Feb 26 2021

- 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.

# 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)

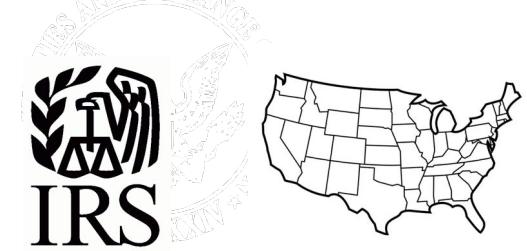


## AML/CFT Laws (FinCEN, OFAC)



# The Long Tail

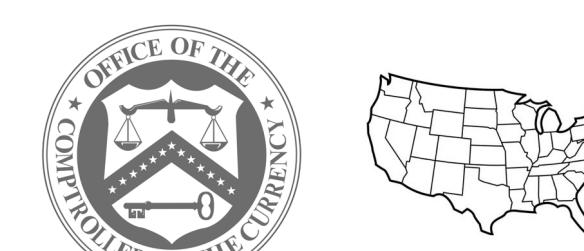
## Tax Laws (IRS, States)



## Consumer Protection Laws (FTC, CFPB, States)



## Banking Laws (OCC, States)



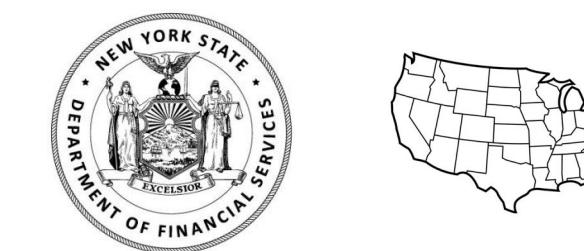
## Lending Laws (States)



## 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**