Course IV:

DeFi Risks and Opportunities

4. Regulatory and Environmental Risk

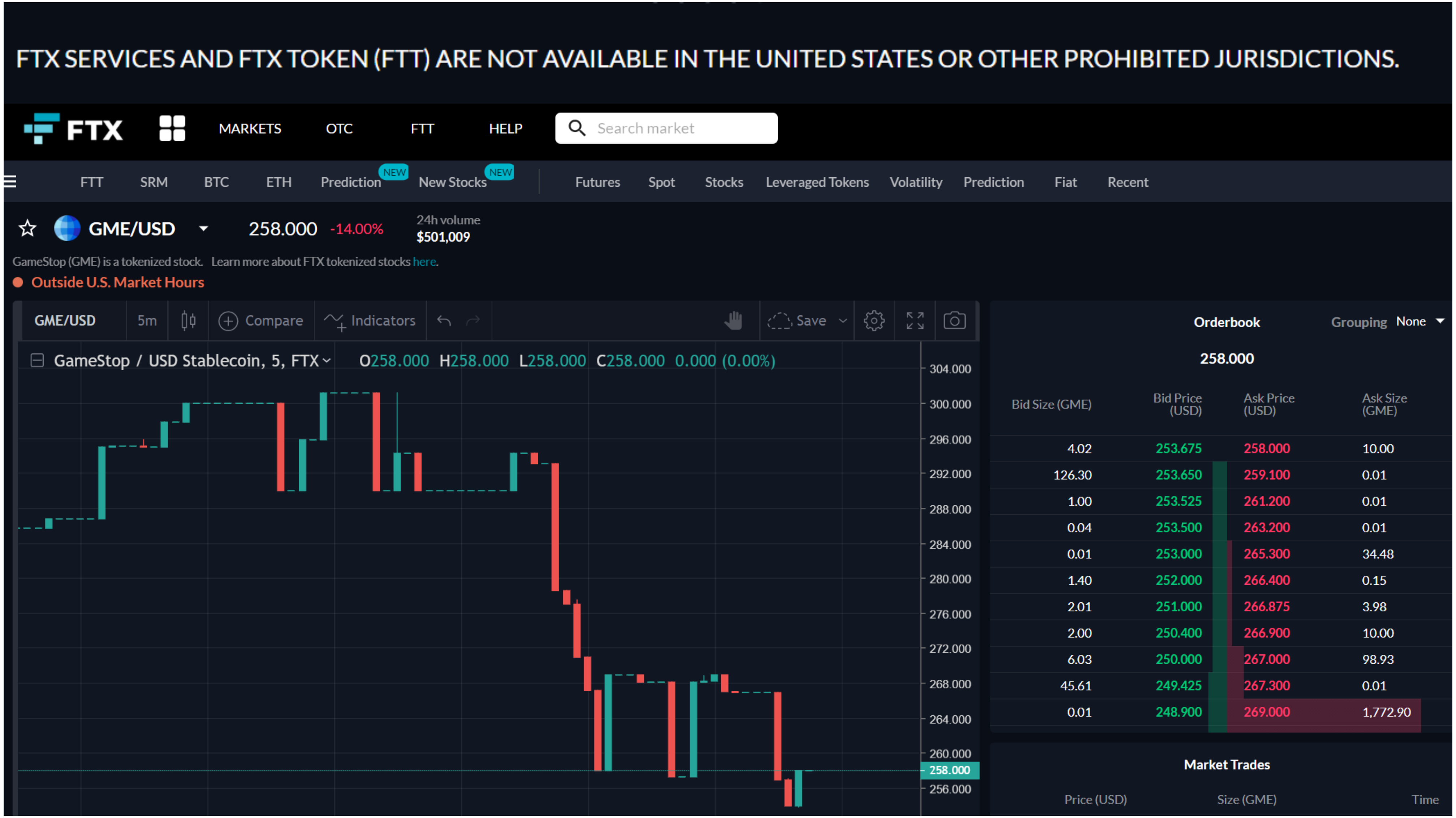
(i) Regulatory

Risks: Regulatory risk

KYC/AML

- Major centralized spot and derivatives exchanges, previously ignored by the CFTC, have recently been forced to comply with KYC/AML compliance orders, and DEXs appear to be next.
- Already, several decentralized derivatives exchanges, such as dYdX, must geoblock US customers from accessing certain exchange functionalities
- Also applies to CeDeFi institutions like Binance

Risks: Regulatory risk



Risks: Regulatory risk

Basis

- A well known algorithmic stablecoin project known as Basis was forced to shut down in December of 2018 due to regulatory concerns.
- A harrowing message remains on their home page for future similar companies:
  - “Unfortunately, having to apply US securities regulation to the system had a serious negative impact on our ability to launch Basis...As such, I am sad to share the news that we have decided to return capital to our investors. This also means, unfortunately, that the Basis project will be shutting down.”

Risks: Regulatory risk

Governance tokens

- Governance tokens, released by many DeFi projects, are also facing increasing scrutiny as the SEC continues to evaluate if these new assets will be regulated as securities.
- For example, Compound, the decentralized money market on Ethereum, released a governance token with no intrinsic value or rights to future cash flows.
- Doing so allowed Compound to avoid the SEC's securities regulation, freeing the company from security issuance responsibilities.

Risks: Regulatory risk

Money-transmitter laws

- Many major market-cap cryptocurrencies have been ruled commodities by the CFTC, exempting them from money-transmitter laws.
- Individual states, such as New York, however, have regulation that targets brokerages facilitating the transfer and exchange of cryptocurrencies.
- As DeFi continues to grow and the total number of issued assets continues to expand, we expect to see increasingly specific and nuanced regulation aimed at DeFi protocols and their users.

Risks: Regulatory risk

Tax

- Cryptocurrency taxation has yet to be fully developed from a regulatory standpoint, and accounting software/on-chain monitoring is just starting to reach mainstream retail audiences.

Risks: Regulatory risk: U.S. regulators

Federal

- Securities Exchange Commission (SEC)
- Commodity Futures Trading Commission (CFTC)
- Treasury Department - Financial Crimes Enforcement Network (FinCEN)
- Internal Revenue Service (IRS)
- Federal Trade Commission (FTC)

Prepared with the help of Trevor Kiviat, Sean Semmler, Zeeve Rose.

Risks: Regulatory risk: U.S. regulators

State

- Securities Laws
- Commodities Laws
- Consumer Protection and Anti-Fraud Laws
- State Money Transmitter Regulations (including NY BitLicense)

Prepared with the help of Trevor Kiviat, Sean Semmler, Zeeve Rose.

Risks: Regulatory risk: SEC

SEC established in the wake of the Crash of 1929

- Idea to protect uninformed investors from fraud in US markets
- Provides guidance on how to comply with laws
- Has <u>enforcement power</u> through civil penalties (criminal handled through Department of Justice)
- Jurisdiction: Sale of securities to US persons

Risks: Regulatory risk: SEC

The offer or sale of any security must be registered under the Securities Act – unless an exemption is granted

When is a digital asset a "security"

1. Asset just represents a traditional security like a stock or a bond, e.g., tokens representing shares (or fractions of shares) of securities
2. An "investment contract"

Risks: Regulatory risk: SEC

Investment contract derived Securities Act and Howey (1946)

- Howey and Co. owned orange groves in Florida
- They offered the following deal. An investor could buy the land and lease it back to Howey who would tend the land, harvest, and market the produce
- It was determined by the Supreme Court this type of leaseback was an "investment contract"

https://supreme.justia.com/cases/federal/us/328/293/

Risks: Regulatory risk: SEC

Howey Test (1946)

- "…an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a **person invests his money** in a **common enterprise** and is led to **expect profits** solely from the **efforts of the promoter or a third party**, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."

https://supreme.justia.com/cases/federal/us/328/293/

Risks: Regulatory risk: SEC

U.S. Securities laws:

- Goal to protect retail investors
- Howey only matters if token is not obviously a security (like equity or debt)
- Under Howey SEC looks at: manner of sale, promotional material, utility vs. speculation

Risks: Regulatory risk: Is it a security?

Decentralized Autonomous Organization

- Investors deposited ETH into a smart contract in return for DAO tokens
- The ETH in the contract was to be used as venture capital
- DAO token holders got to vote for various investments
- Clear expectation of making profits from the initial investment
- SEC rule The DAO was a security

Risks: Regulatory risk: Is it a security?

Decentralized Autonomous Organization

- July 26, 2016 The SEC rules that DAO tokens were “securities” subject to federal securities laws.
- *…issuers of distributed ledger or blockchain technology-based securities <u>must register</u> offers and sales of such securities unless a valid exemption applies. Those participating in unregistered offerings also may be liable for violations of the securities laws. Additionally, securities exchanges providing for trading in these securities must register unless they are exempt. The purpose of the registration provisions of the federal securities laws is to ensure that investors are sold investments that include all the proper disclosures and are subject to regulatory scrutiny for investors' protection.*

https://www.sec.gov/news/press-release/2017-131

Risks: Regulatory risk: Is it a security?

In a sale of a security in which the security is **offered or sold** to U.S. persons the **issuer** must:

1. Register the Securities with the SEC
    - This is an expensive option that most startups cannot afford

2. Find Registration Exemptions (Safe Harbors)
    - Regulation D – Private Placement and General Solicitation
        - 506(b) – limit of unaccredited (must be sophisticated), unlimited raise, unlimited Accredited Investors, no general solicitation.
        - 506(c) – only Accredited Investors, burden on issuer to confirm accreditation status, unlimited raise, general solicitation allowed.
    - Regulation S – Offerings outside the US to non-US persons

Risks: Regulatory risk

- **Balancing act**
  - Too much regulation drives innovation offshore – too little regulation leads to consumer exploitation
  - New technology is complex
  - Difficult for regulator to invest time to understand
  - Even if they are trained, their knowledge quickly becomes stale
  - Difficult for regulators to recruit talent that understands space.