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FATF and DeFi
Further thinking is required

The Digital Regulator

Redefining Finance for the New Economy

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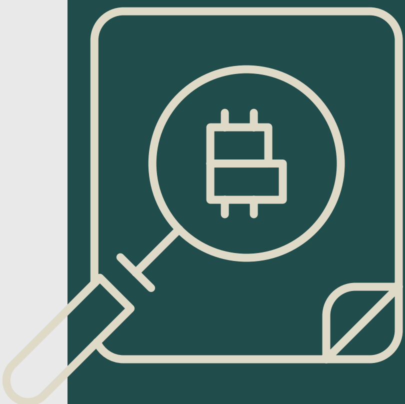

Executive summary

On 19 March 2021, the FATF issued an update to its 2019 Guidance on the risk-based approach to virtual assets (VAs) and virtual asset service providers (VASPs) for consultation. The consultation was concluded on 20 April 2021, and the FATF will report its way forward in June 2021. Among other aspects, the proposed updates broaden the definition of VA and extend the definition of VASP with the goal to ensure that all digital financial assets are captured by FATF standards. The FATF is attempting to extend an approach that is constructed around the notion of centralised intermediaries (e.g. banks and exchanges) and the possibility of expert judgment (e.g. assess the suspicious nature of transactions) on highly automated, per definition decentralised, DeFi protocols. If the update is not modified to account for the specificities of DeFi, the final Guidance may cause the overregulation of the digital financial industry and disincentivise financial innovation.

In the previous few weeks, the digital space has been witnessing several noteworthy regulatory developments. Several jurisdictions made or anticipated significant progress in central bank digital currencies (CBDCs) based on their fear that private stablecoins might weaken monetary sovereignty unless they offered the public a valid alternative. The significant trading gains associated with the development of cryptocurrency prices are driving many countries to issue dedicated taxes on trading gains. Turkey is implementing regulatory actions following the collapse of the Thodex and Vebitcoin exchanges. The US Congress has initiated decisive steps to clarify the regulatory framework for the US cryptocurrency market. Further, the European Central Bank (ECB) published the results of its public consultation on the launch of a digital euro and indicated privacy and security as the main concerns. Finally, due to the actions taken by the Canadian regulator, North America enters the cryptocurrency exchange-traded fund (ETF) space.

The updates proposed by the Financial Action Task Force (FATF) to its Guidance on the risk-based approach to virtual assets are not conducive to the development of sustainable Decentralised Finance (DeFi). They require further thinking.

1. Necessity of further developing the FATF's draft on the update to the Guidance for a risk-based approach to VAs and VASPs

As mandated by the G20 in the aftermath of the early 2018 bitcoin and initial coin offering boom, the FATF elaborated on and adopted changes to its internationally endorsed global standards against money laundering (anti-money laundering, AML) and terrorism financing (combating the financing of terrorism, CFT) in October 2018 to explicitly clarify their application to financial activities involving VAs. Subsequently, in June 2019, the FATF further clarified the standards' application to VAs and VASPs and published the Guidance on the risk-based approach to VAs and VASPs. On 19 March 2021, the FATF issued its proposed updates to this Guidance for public consultation. The updates address, among other things, the application of the global standards to peer-to-peer (P2P) transactions, including DeFi and stablecoins.

Scope of the proposed updates

- The proposed revisions focus on six key areas. The first is concerned with the clarification of the definitions of VA and VASP. The clarification aims to include all relevant digital financial assets that are not covered by the standards yet (level playing field). The second area covers the standards' application to stablecoins, whereas the third provides additional guidance on the risks and potential risk mitigants of P2P transactions, including DeFi. Updates to the guidance regarding VASP licensing and registration come under the fourth area. The fifth area is associated with further improving and clarifying the implementation of the 'travel rule' by private and public actors. Finally, the sixth area addresses the issues of information sharing and cooperation among supervisors. In addition, the updates clarify that CBDCs are not considered to be VAs.

Problem with the widespread use of P2P protocols

- The revised guidance highlights P2P transactions and recognises that such transactions are not currently explicitly subject to the FATF global standards since these are constructed around the notion and existence of a (centralised) financial intermediary (VASP), rather than on the transacting individuals themselves. The widespread use of disintermediated transactions, including cases when P2P transfers occur automatically through smart contracts under the governance of a DeFi protocol, will jeopardise the effectiveness of AML and CFT controls. DeFi emerged during 2020 and, since then, has managed to attract an exponential increase in funds, with the latest figures indicating that over USD 85 billion are locked in DeFi smart contracts[1]. DeFi effectively decentralises and automatises as many traditional financial services as possible, including payments, lending, trading, and exchanges, through smart contracts that carry out P2P transactions in a deterministic manner without involving (centralised) financial intermediaries and leaving no space for discretionary judgment.

Expansion of VA and VASP definitions as a solution

- The revised guidance makes it clear that the definition of VA should be technologically neutral and focus on the asset's digital nature and payment or investment purpose. Further, a functional approach should drive the definition of VASP, which should encompass transactions, or businesses, among natural and legal persons, such as exchanges between VA and fiat currencies, exchanges between one or more VA forms, VA transfers, VA safekeeping and/or administration, and participation in and provision of VA-related financial services. The FATF indicates that decentralised or distributed applications (DApps) that typically underlie P2P transactions, including DeFi protocols, are not VASPs. However, it also indicates that some entities involved in DApps may be VASPs. Being a VASP, in turn, requires conducting Know-Your-Customer, AML, and CFT checks on the individual controlling the VA, performing sanctions screening, assessing and reporting on the suspicious nature of transactions, and applying the travel rule to the transactions.

[1] Source: https://defipulse.com/

Unintended consequences

- As currently specified, the revised guidance will certainly define as VASPs several parties involved in DApps, such as the owners, controllers, operators, and developers of DeFi. These individuals would not be deemed VASPs in the context of centralised financial intermediaries. These decentralised parties will be required to implement the compliance requirements mentioned in the previous paragraph, meaningfully coordinate the implementation of these requirements, and overcome major challenges, such as introducing the possibility of judgmentally assessing the potentially suspicious nature of each automatically and deterministically transacted VA. The proposed revision, as currently defined, will promote the centralisation of DeFi or heavily discourage DeFi and disincentivise the associated financial innovation, which is considered a positive development based on the huge interest generated by DeFi, including from the traditional finance world.

The FATF intends to ensure sustainable finance by controlling and limiting the illicit use of financial instruments and processes to launder money and finance terrorist activities. All parties involved undisputedly support this intention and goal. However, as discussed earlier, the revisions to the Guidance for a risk-based approach to VAs and VASPs currently proposed by the FATF do not achieve the goal. If the current proposition is implemented as it is, the revised requirements will severely disincentivise the broad distributed ledger technology (DLT)-based financial innovation that comes under the umbrella term of DeFi, which is supported by both DLT-based and traditional finance. Further, if they are signed off as such in June 2021, the revisions proposed by the FATF will have to be implemented at the national level by national supervisors, who will be required to specify the operational side of its implementation. Accordingly, the national supervisors will have to assume the responsibility of maintaining an adequate balance between the safeguarding of positive DLT-based financial innovation (bringing about efficiency and inclusiveness in finance) and the potential of these financial applications to be misused for money laundering and terrorism financing purposes.

2. Other Noteworthy Developments

Several jurisdictions are making or anticipating significant progress in the area of CBDCs. The common denominator among them seems to be the concern that private stablecoins may weaken monetary sovereignty if the jurisdictions fail to offer a valid alternative to the public.

- Japan has decided to accelerate its CBDC testing program and will begin experimenting the CBDC program later this year. It has not yet announced any plan to issue its CBDC but intends to expedite preparations in case of a future need to issue the CBDC. To facilitate the process, the Bank of Japan created a 'liaison and coordination committee' to coordinate the actions of the central bank and private sector.
- China has initiated efforts to grant international interoperability to CBDCs. According to the People's Bank of China, there should be a set of rules that are globally applicable to CBDCs to provide guidance on sensitive issues such as information-sharing and monitoring activities. Domestically, China has extended its CBDC testing program to include a Shenzhen population comprising 500,000 citizens, who have been asked to open a digital yuan wallet account.
- Russia announced the issuance of a CBDC prototype in autumn, and it will start piloting its CBDC in 2022. The country's intention is to gain market dominance and limit the use of stablecoins in settlements upfront.
- Thailand will start testing its retail CBDC in 2022. The central bank fears that the success of private stablecoins may threaten its monetary sovereignty.
- The Eastern Caribbean Central Bank has launched its CBDC, called DCash. The DCash is a digital version of the Eastern Caribbean dollar, which is the official currency of the eight countries making up the Eastern Caribbean Currency Union.
- In the United Kingdom, the Bank of England and His Majesty's Treasury teamed up to launch a CBDC task force. The task force is responsible for coordinating the objectives, use cases, opportunities, and risks of a potential UK CBDC.

The significant trading gains associated with the price of cryptocurrencies are encouraging many countries to issue dedicated tax on trading gains.

- Indonesia is considering levying a tax on all cryptocurrency transactions occurring on regulated exchanges. Further, Norway's tax authority reminds taxpayers to declare their 2020 gains, on which a 22% tax rate is applicable. Finally, in Spain, the tax agency has summoned crypto holders to declare their 2020 holdings.

Turkey is implementing regulatory actions following the collapse of the Thodex and Vebitcoin exchanges.

- In Turkey, two local exchanges–Thodex and Vebitcoin–collapsed in the space of a few days and caused the Central Bank to accelerate the substantial policy response for already initiated digital currencies and consider the creation of a new custodial bank for the crypto funds of domestic crypto exchanges.

Eventually, the US Congress initiated decisive steps to clarify the regulatory framework of the US cryptocurrency market.

- The US Congress House of Representatives passed a bill to clarify the roles of agencies like the Securities and Exchange Commission and Commodity Futures Trading Commission in the policing of cryptocurrencies in the country. Further, the bill addresses the ongoing debate on whether crypto tokens are securities or commodities. The Congress has 90 days to establish a working group involving the aforementioned regulatory agencies and the private sector, and the group is required to issue a report analysing the situation and making proposals within a year's time.

The ECB published the results of its public consultation on the launch of a digital euro.

- The ECB published the results of its public consultation on a digital euro that was launched some time ago. Most of the respondents indicated privacy and security as the main concerns associated with a potential digital euro and, thereby, established various priorities.

Due to the efforts of the Canadian regulator, North America entered the cryptocurrency ETF space.

- In early 2021, Canada became the first North American country to introduce a bitcoin ETF. More recently, Canada's securities regulator approved the world's first Ethereum ETF. In contrast, the US Securities Exchange Commission has delayed making any decision on the VanEck Bitcoin ETF proposal for a 45-day period.

3.
Conclusion

The transformation of traditional financial products, services, and processes is ongoing, and the development of DLT-based finance is an important part of it. Over the past 20 months, we witnessed the emergence of numerous DeFi protocols, which significantly enhanced efficiency and inclusiveness in finance. The interest is considerable. Currently, over USD 85 billion is locked in DeFi, and both traditional and DLT-based financial professionals are supporting DeFi. Appropriate regulation should marginalise illicit use cases, promote sustainable solutions, and address new innovations. To address these challenges, the FATF has proposed updating its Guidance for a risk-based approach to VAs and VASPs. Regrettably, the proposed amendments extend an approach that is based on the centralised intermediaries and on the possibility of operating human judgement (e.g. assess the suspicious nature of transactions) on highly automated DeFi protocols. If national supervisors, who will likely be assigned the responsibility of implementing the proposed updates as such, fail to balance the safeguarding of positive DLT-based financial innovation and the limitation of these financial applications to be misused for money laundering and terrorism financing, an overregulation of the digital financial industry and disincentivising of positive financial innovation may occur.

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