



Decentralised Finance and Anti- Money Laundering Legislation – Are We Heading Towards A Collision Course?

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The rise of Decentralised Finance, ‘DeFi’, has transformed the way we think about traditional finance and the future of financial services, and has opened up endless possibilities for digital asset marketplaces to develop and flourish. We are already seeing this in the form of global engagement, where serious institutions have begun to recognize the value of unparalleled security, authenticity, and traceability for assets in a digital setting.

It is a well known fact that the financial industry is heavily regulated, even more so since 2008, presenting a monolithic, centralized banking infrastructure that makes it hard to disrupt and arguably tedious to transform. Compare it with the vertiginous pace of creativity and innovation in the cryptocurrency and decentralised ecosystem, as a large number of new financial products and instruments in the DeFi space have been launched, and are being launched almost weekly.

The law can barely keep up with the pace of innovation and DeFi in particular is posing unprecedented challenges from a legal and regulatory point of view.

The most prescient issue to be addressed is whether the defining principle of ‘trustlessness’, (the absence of a ‘trusted’ intermediary such as a bank), can be compatible with anti-money laundering, and Know Your Customer, (KYC), regulations. How can a peer-to-peer system be reconciled with, and fitted into a centralised, intermediary- based and tightly regulated legal framework?

In this blog I intend to look more closely at some of the key DeFi features in order to understand the legal and regulatory challenges that may lie ahead.

Tokens and tokenization of assets

Ethereum, with its long- awaited upgrade Ethereum 2.0, has been hailed as the platform to usher in the next generation of the Internet. For the moment, Ethereum is a frenetic hub of development of new technologies in the form of decentralised

applications, (Dapps), and other blockchains which are built and run on top of the Ethereum network.

As Ethereum 2.0 gears up for its transition, there's a lot in store for 2021. Both DeFi and Ether (ETH) have been doing exceptionally well; with the native Ethereum token recently retracing its all-time high and even reaching a \$2,000 valuation.

However, there have been serious scalability issues as the number of transactions increased on the Ethereum network, so did the cost of performing these transactions, which are paid in Gas. But despite scalability issues, DeFi has brought a breath of fresh air to the cryptocurrency space, spawning numerous new tokens that have revolutionised decentralised lending and borrowing services.

Projects like Uniswap resurrected the concept of decentralised exchanges, (DEX), using an automated market maker model, (AMM). This allows the system to price trades without relying on liquidity from a counterparty. Instead of using order books, the AMM prices assets using the ratio of tokens in a liquidity pool to determine supply and demand.

Uniswap's surge in use has been fuelling the DeFi engine with daily trading volume rising from around \$1 million to \$1 billion between July 2020 and September 2020, according to experts. Unlike a fiat-based system tied down by order books, Uniswap can execute orders on-chain, meaning transactions are made and settled on the network directly, and this has become one of Ethereum's most prominent features.

Tokenization of real-world assets is a prominent feature of the DeFi universe. The coming into force in February 2021 of the newly amended Swiss legislation, the so-called 'Blockchain Act', has opened up an already burgeoning digital assets market. This new piece of legislation allows all tokenised assets from digital-only versions of company shares, to real estate holdings, art, luxury items, such as diamonds, and fine wines to be lawfully listed and traded on the blockchain. The Swiss legislation now legitimises the tokenisation of assets, and opens up accessibility and liquidity to investors. It is revolutionary in that for the first time tokenisation of assets is legally recognized as a viable alternative to traditional securitization. Ownership records of the tokens recorded on the blockchain ledger is legally binding and a token has the same characteristics as a written agreement/contract.

This is an important step towards mass-adoption of the technology and cements a legitimate future for DeFi. And this has been accompanied by a rising trend in crypto-native institutional investors seeking higher yields via stablecoins. Many of these investors have been using centralized exchanges, (CEX) – which are of course financially regulated entities – but a handful of institutionally focused self-custodial products have emerged, which will trigger increased regulatory scrutiny on DeFi as these services gain traction.

So far, regulators around the world have focused on enacting stricter rules for virtual account service providers, such as centralized crypto exchanges. The Financial Action Task Force's travel rule and Europe's 5th Anti-Money Laundering Directive point toward stricter Know Your Customer standards in cryptocurrency, and SEC's legal suit against BitMEX in the U.S. brought this into sharp relief in October last year. This will ultimately touch DeFi.

Large institutional investors, such as pension and insurance funds, require highly sophisticated and liquid markets, lengthy historical data and track records, as well as needing to overcome significant internal risk and regulatory assessments. These hurdles are multiplied when it comes to using crypto protocols.

For example, a company looking to use digital tokens representing a firm's shares on the Ethereum blockchain must adhere to existing financial and capital market regulations globally. This includes aspects, such as cross-border KYC and Anti-Money Laundering regulations.

Therefore to enable institutions to adopt DeFi, the ecosystem must provide them access in a compliant and legally secure manner. This does not mean that all DeFi must be unduly regulated; this would defeat the purpose of a decentralised system. The main challenge is to develop and introduce a protocol to facilitate the compliant use of DeFi. There are several aspects that make up such a system.

Digitisation

While it may be easy to create a digitised asset, the difficulty arises when compliance/regulation is introduced. One of the key challenges centres around global securities regulation where there is a range of required actions to undertake before issuing a security, including consulting legal advice, documentation, due diligence, marketing and secondary trading, and corporate actions. This arguably cumbersome process can create an opportunity for DeFi. A protocol able to solve these issues would significantly reduce a firm's capital and resource expenditure while also improving the process for investors who would be able to access and trade in a similar manner to crypto assets today.

Due diligence checks

Due diligence checks including KYC and AML are a costly and mandatory process for financial institutions. Anyone investing in multiple firms across multiple jurisdictions must complete the same checks with each of them — a time-consuming process for all parties, which also raises issues of data transference and security, the investor having to trust multiple institutions with sensitive data.

Arguably, DeFi can offer the opportunity to redefine how KYC is carried out. Instead of each firm doing its own KYC, an investor could conduct KYC protocols with an approved partner. This would enable the investor to retain control of their data, while institutions could share the burden of the KYC cost across each other. Institutions would, of course, be able to complete their own KYC if they did not approve of the KYC operator. Such protocols are already being considered.

Data

Access to — and control of — data has become ever more contentious. The two prominent issues facing institutions regarding data are the security and privacy of users' data, particularly post General Data Protection Regulation, as well as the ability to connect to DeFi through easy-to-use application programming interfaces, (API).

User data can be protected using encryption methods such as zero-knowledge proofs, which enable users to share validated data with a third party without the data being revealed to the said party. This would allow investors to prove they are eligible to complete a transaction without having to prove who they are or why they are eligible. This is an important feature for DeFi: data can be encrypted and stored securely while always remaining in the hands of the user.

Institutions also require an easy way to share data. This can be achieved through APIs that will make it easy for institutions to connect to DeFi protocols while remaining compliant with regulations facilitating both on-chain and off-chain data.

Cross-border regulation

Investors expect to be able to invest globally rather than being constrained to their own jurisdiction. Blockchain technology, with its ability to digitise assets and transact instantly with peers globally, can provide a means to achieve this, but it requires firms to be able to maintain the same regulatory standards.

That is why it has been argued that a protocol is needed that can embed regulation at the layer level. Once a rule has been created or amended and subsequently accepted as smart contract logic, firms have no choice but to adhere to it. Furthermore, this can be tied in with the previously mentioned KYC checks to ensure an investor is able to invest in the product they want. This automated, built-in regulation at the layer level of cross-border transactions, can significantly reduce costs for institutions.

The Future of DeFi

DeFi is still in its infancy, and liquidity is still too thin in comparison with more established asset classes for institutions to bother upgrading their knowledge, let alone their IT systems to deploy capital into it. Additionally, there are real, serious operational and regulatory risks when it comes to the transparency, rules, and governance of these products.

There are many things that need to be developed — most of which are already underway — to ensure institutional interest, and therefore legal and regulatory legitimacy in DeFi products, whether on the settlement layer, asset layer, application layer or aggregation layer.

Institutions' primary concern will undoubtedly be to ensure the legitimacy and compliance of their DeFi counterparts at both the protocol level and the sale/execution level.

One solution will be developing a protocol that recognizes the status of a wallet owner or of another protocol and advises the counterparty as to whether or not it fits its requirements in terms of compliance, governance, accountability and also code auditing, as the potential for malicious actors to exploit the system has been proved over and over again. This solution will need to go hand in hand with an insurance process to transfer the risk of an error, for example, in validation to a third party.

On a personal level, the point would be the need for improvement in user experience/user interfaces in order to turn complex protocols and code into a more user-friendly, familiar interface which can be used not just by a selected few.

Conclusion

The coming decade will usher in an era of digital asset marketplaces with financial instruments and protocols that are fully decentralised, fully open source, and fully anonymous. The fantastic rate of creativity and the relentless innovation in the sector will continue as a large number of new products in the DeFi space are anticipated. And within a decade or so, once DeFi has absorbed capital markets, its full potential will be unleashed, leading to a frictionless, decentralised, self-governing system.

The revolution is here, and it is here to stay. But it will require a fine balance to tread between tech-based, fast-paced crypto and antiquated, rigidly regulated fiat systems. Building a bridge between the two worlds will be the greatest challenge of the coming decade, and as a lawyer in the cyber space, I look forward to it.

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