
Consultation Response

AMF Discussion Paper on Decentralised Finance (DeFi) Trading Protocols and Governance Issues

September 29th 2023

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the AMF's **DISCUSSION PAPER ON DECENTRALISED FINANCE TRADING PROTOCOLS AND GOVERNANCE ISSUES** ("the DP"). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Executive Summary

AFME welcome the AMF's efforts to engage with and examine developments within the industry such as the increased adoption of distributed ledger technology ("DLT"). Recognising the benefits that DLT can bring to the development of a thriving EU digital economy, we are also conscious that the risks and potential regulatory gaps must be addressed in order to ensure a focus on safety and robustness.

In July 2023 we published a whitepaper on "[Decentralised Finance: Principles for Building a Robust Digital Economy](#)"¹. We have attached it as an annex to this response, as we feel it addresses many of the areas raised in the AMF's DP. In particular, it discussed three main themes:

1. The importance of developing a foundational taxonomy classification mechanism for DeFi (and DeFi activities) as well as digital assets;
2. The need to encourage further research and global cooperation to determine the appropriate, proportionate, and comprehensive regulatory solutions for the unique challenges posed by DeFi; and
3. The importance of leveraging existing processes and frameworks to create a holistic regulatory perimeter.

We encourage the AMF to review our whitepaper and would be happy to discuss any of the areas in more detail. In addition, we have outlined below three additional issues for consideration, prompted by the DP itself:

- Governance of Decentralised Autonomous Organisations ("DAOs");
- The value in tracking approaches to DeFi in other jurisdictions; and
- The importance of conformity with global frameworks.

¹ <https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20DeFi%20Whitepaper.pdf>

Governance of DAOs

The goal of a DAO is to be a democratic organisation that is led by its community where participants propose actions which get voted on by the community. Voting rights may be assigned according to the amount of investment (e.g. number of tokens) but, more commonly, are assigned according to the number of participants (e.g. one member one vote) (a "Fully-formed DAO"). There can also be hybrid approaches. In practice, before becoming Fully-formed DAOs, DAOs start off as a project where the founders design the DAO, run it and then sell governance tokens in order to raise finance to slowly achieve their objectives (a "DAO Project").

We note that in the DP you raise a number of good points in relation to the risks and issues of protocol DAOs and of DeFi protocol governance. As the objectives of a DAO Project may not necessarily be to support the operation of DeFi protocol running a DeFi use case such as collateralised lending, we believe that it is necessary to consider how French law would look at the governance arrangements of DAO, completely independently from the services that the DeFi element provides. Indeed some DeFi protocols will not have a DAO or controlling entity (i.e. they just act as open source software and cannot be changed or updated) and, over time, as more protocols are added, there will be an increasing number of protocols where the DAO that created them no longer functions but the software remains operational on the blockchain. This focus on both governance and services also respects the principle of "same activity, same risk, same regulation" and the generally accepted need to remain technology agnostic.

In essence, we think that there are two questions that must be considered independently:

1. How DAO-like unincorporated associations should be treated under French law, including whether they should be awarded legal personality and, if not, whether all members would be liable jointly and severally; and
2. How the regulatory framework should apply to any licensable activities that such organisations carry out.

Whilst it is clear that existing financial services regulation can apply to financial activities carried out by DeFi protocols, the fundamental issues surrounding the governance of DAOs remain.

Applying legislative frameworks to DAOs

One view is that the DAOs have features which mean that they fall within the scope of existing legal frameworks. This is consistent with the approach taken in the CFTC's recent action in a Californian court against Ooki DAO, where the DAO was qualified as a "US legal person" organised as an "unincorporated association" providing services in relation to financial products². The Californian judge actually justified his decision by referring to how the initial DeFi project sponsor had intentionally set up the DAO to avoid the applicability of financial regulations, in order to keep the DAO members fully anonymous. We also understand that, depending on their set-up, under English law certain DAOs could also qualify as unincorporated associations of persons.

Another possible approach is that of several jurisdictions (e.g. the States of Vermont, Tennessee, Utah, and the Cayman Islands) which have equipped themselves with DAO "legal wrappers", which offer DAOs that are unincorporated to obtain a distinct legal status. These legal forms range from foundations, to not-for-profit organisations, to specific designations as Decentralised Organisations.

Identifying responsible persons

One of the problems with trying to apply existing legislative frameworks with DAOs is that as they do not have the same type of governance arrangements as more traditional entities, e.g. a board of directors, executive

² <https://www.cftc.gov/PressRoom/PressReleases/8715-23>

officers, risk committees etc. Without a legal provision that specifically deals with this issue in respect of DAOs, it can therefore be difficult to determine whether one or more DAO members should be responsible and bear any legal and civil responsibility for actions carried on by their DAO. Existing financial services regulatory frameworks are built on the notion that the regulated firm is responsible for its activities and that the senior decision makers carry additional responsibility in respect of the performance of their functions. For DAOs, where no such responsibility can be allocated, this may act as a significant hurdle in obtaining authorisations to carry out regulated financial activities and demonstrate continuing compliance with the regulatory framework.

Current proposals to deal with this issue centre around arbitrarily assigning responsibility to individual(s) according to pre-set criteria. One example involves assigning responsibility to those individuals holding the biggest share of DAO governance tokens, although this approach is imperfect as the identity of those individuals might change with regular frequency. Another example involves assigning responsibility to those individuals who were the key decision makers of the DAO Project, however this approach is also imperfect as such individuals may eventually hold limited or zero governance tokens and therefore have no input on the development of the relevant protocol.

Members of DAO are not shareholders who join a queue of creditors on insolvency, nor directors (whose appointment might be voted upon by shareholders) remunerated to manage, nor employees who are remunerated to carry out specific roles. In particular, while some DAO members may participate in the DAO in order to obtain a return on their investment, this is not necessarily the case, such that it may be inappropriate to look at corporate governance models for inspiration.

Ultimately, there must be a pragmatic legal solution given so that there is legal certainty as to the level of responsibility that a particular member of a DAO accepts when participating in the DAO. This is a question that will have to be decided at legislative level.

Regulating DeFi

In relation to the question of how the regulatory framework should apply to any licensable activities that DAOs carry on, the starting point has to be the principle of same activity, same risk, same regulation, which must prevail at all times. If a company or a bank were to establish a DeFi protocol to carry out financial activities, such company or bank would be treated as carrying out financial activities and be regulated accordingly. If a DAO is issued to establish a DeFi protocol to carry out financial activities, the DAO should be treated in the same way. If there is no applicable legal form for such DAO (or such DAO cannot obtain authorisation as a legal form as it does not have the governance arrangements to convince regulators that they can comply with applicable regulation) and there no law setting out how to identify the responsible parties for such DAO (see above for the various options), in theory each individual member of the DAO may be liable for the financial activities carried out by the DAO (as would be the case for an unincorporated association).

Whilst there may not be obvious answers for the two questions we have raised, in the interim clearer guidance is needed from regulators as to their expectations as to how certain compliance obligations should be met in the DeFi space. For example, to what extent is it necessary for DeFi protocols or the DAOs behind them to carry out AML and sanctions checks on users of the relevant DeFi protocol? There may be technical constraints to consider too. A DAO is a community which votes on matters which are then reflected through updates of code by developers of a DeFi protocol. It may therefore not be possible for a DAO to carry out compliance checks, although such DAO could in theory vote to delegate responsibility to a third party using or connected to the DeFi protocol.

Other Jurisdictions' Approaches to DeFi

We would encourage legislators and supervisory bodies to closely follow developments across the globe in relation to the regulation of DeFi. For example, there has recently been reform in Abu Dhabi with the introduction of the DLT Foundations Regulations. Abu Dhabi's DLT Foundations Regulations' key innovation is in granting legal personalities called 'DLT Foundations' to DeFi organisations to operate and conduct business in the physical jurisdiction of Abu Dhabi. There is a focus in the legislative framework on corporate governance provisions and providing operative guidelines regulating how decisions should be taken by a DLT Foundation. It also sets out provisions relating to token issuances, disclosure and auditing requirements and the functional day-to-day operations of a DLT Foundation. Concepts covered in these guidelines mirror that of company laws in various jurisdictions, for instance, the concepts of 'shareholders' and 'tokenholders' are used. DLT Foundations are permitted to engage in any activity that is not illegal or contrary to public policy. Statutory and judicial interpretations of 'public policy' and 'illegal' to be applied to DeFi activities and transactions will therefore influence the development of DeFi in Abu Dhabi.

AFME will also be responding to the International Organization of Securities Commissions' (IOSCO) consultation on Policy Recommendations for Decentralized Finance, through the Global Financial Markets Association.

Adherence to Global Frameworks

Conforming to global regulatory frameworks is of paramount importance in the context of DeFi due to the relative nascent and fast evolving nature of this financial ecosystem. DeFi, empowered by blockchain technology, has emerged as a disruptive force, offering innovative financial services that transcend traditional borders. However, without adherence to global regulations, it risks becoming a potential breeding ground for illicit activities, financial instability, and potential harm to investors. Moreover, the absence of harmonised regulations across borders could lead to regulatory arbitrage, where entities exploit regulatory gaps to their advantage, further exacerbating these risks. Global governing bodies, including IOSCO, the Financial Stability Board (FSB), the Financial Action Task Force (FATF), the Basel Committee on Banking Supervision (BCBS), and the International Monetary Fund (IMF), play pivotal roles in developing and enforcing standards to address these concerns. Embracing these regulatory frameworks will ensure investor protection, promote market integrity, and foster trust in DeFi platforms. Furthermore, compliance enables the industry to engage with traditional financial institutions, paving the way for greater adoption and integration into the broader financial landscape while safeguarding the global financial system from systemic risks associated with unregulated DeFi activities.

AFME Contacts

Stefano Mazzocchi
Managing Director, Advocacy
stefano.mazzocchi@afme.eu
+32 479 027 989

Andrew Harvey
Managing Director, Technology & Operations
andrew.harvey@afme.eu
+44 20 3828 2694

Coen ter Wal
Director, Technology & Operations
coen.terwal@afme.eu
+44 20 3828 2727

Coco Chen
Associate Director, Technology & Operations
coco.chen@afme.eu
+44 (0) 203 828 2749