*bàdasl*

2 October 2023

Autorite` des Marches Financiers
Submitted via email: innovation@amf-france.org

Dear Representatives,

**Contribution to the Autorite` des Marches Financiers' Discussion Paper on Decentralised Finance**

Thank you for the opportunity to provide comments on the Discussion Paper on Decentralised Finance (**DeFi**) published on 19 June 2023 (**Discussion Paper**).[1]

We invite the Autorite` des Marches Financiers (**AMF**) to refer to related and previous policy submissions made by BADAS*L at www.badasl.com/policy.

The efforts of the AMF to understand the relevant factors in defining a regulatory scope for DeFi are to be applauded. Much helpful guidance can be absorbed by regulatory bodies and the global web3 sector from the Discussion Paper, particularly around understanding DeFi and what activities are similar or different to traditional financial market infrastructure and activities.

BADAS*L's high level comments on the Discussion Paper are set out below.

1.      We agree that:

*Regarding Discussion point 1*

a.      the assessment of whether a blockchain is permissionless should include an assessment as to the degree of permissibility of the blockchain that focusses on:

   i.      defining the suite of activities that a person can participate in within a blockchain network (e.g. onboarding users, validating transactions, initiating transactions); and

   ii.      per activity, evaluating how many entities, individuals, users, or nodes can control the activity; and

b.      the evaluation of whether an activity falls within the remit of DeFi should include an assessment of whether a blockchain is permissionless; *however*, BADAS*L suggests this 'activities-focussed' evaluation should also extend to an evaluation of the model of governance of an application deployed on a blockchain or deployed on an application-specific blockchain (e.g. Cosmos, Polkadot, Avalanche);

*Regarding Discussion point 2*

c.      it is possible for smart contracts to include rules that meet existing legal or regulatory requirements; *however*, as the AMF rightly identifies, existing legal or regulatory requirements should not be implemented without first reviewing their effectiveness to deliver the same regulatory outcome – that is, existing legal or requirements may not be appropriate and adapted to achieve the same regulatory outcomes for the idiosyncratic risks of DeFi activities that rely upon decentralised global digital infrastructure (e.g. "stop

---

/ start" type mechanisms may be possible and appropriate at the application level such as for USDC circulating on the Ethereum blockchain, but would likely not be sensible at the blockchain "L1" or "L2" levels);

d. smart contracts should be the subject of legal or regulatory requirements; **however**, BADAS*L suggests more nuanced language and a limiting principle that is technology neutral as follows:

    i. the nuanced language should reflect that heightened obligations apply in relation to code made publicly available under an open-source licence (or effectively under an open-source licence) and which is intended to be deployed immutably, for example:

        1. those creators of open-source smart contract code that intend to deploy code immutably (i.e. no admin or upgrade keys retained) should be the subject of either:

            a. upfront legal and regulatory requirements prior to the code being deployed, which may include a defined period of sandbox-type testing with limited participants and limited financial value involved; or

            b. legal and regulatory requirements at the time of 'forking' the original code with modifications, which could include disclosure and conduct obligations around abandoning code such as clean up, adding warning labels to abandoned code including any legal consequences to the person of using abandoned code, and redirection notices to upgraded code;

        2. where open-source smart contract code has already been deployed immutably, then either:

            a. the creator remains responsible for ongoing legal and regulatory requirements if no model of decentralised governance was implemented (i.e. it would not be enough to design a model of governance but not take steps to ensure it is implemented); or

            b. those persons presently participating in the governance of the smart contract code (and any periphery code required for the smart contract/s to function) should be the subject of ongoing legal and regulatory requirements that focus on the ongoing security of the activities and resilience to withstand threats to crypto-token units representing financial value that are managed by the smart contract code (e.g. ongoing obligations to regularly scan for and monitor the use of the open source smart contract code in other applications to understand downstream security and financial risks);

    ii. the limiting principle should nod to IOSCO principles including those around reducing risk of human fraud and operational risks, and should cover smart contract 'primitives' such as the wrapped ether contract – so, for example, where a smart contract has experienced substantial use without any security exploits and without causing economic loss across other smart contracts for a sufficient period, then ongoing legal responsibility of the creator expires and there is no legal

requirement to maintain of model of governance;

*Regarding Discussion point 3*

e. the use of open-source software (or effectively open-source software) is a distinguishing feature of DeFi; **however**, greater transparency, auditability and composability of open-source software do not guarantee, without further effort, that participants – especially retail participants - will understand the data available to self-evaluate the risks of their participation with a smart contract or blockchain or the risks based on that smart contract's connectedness (or not) with other smart contracts – accordingly, if a smart contract is available to retail participants then the model of governance should include a workstream (or subdao or working group or third party contractor) responsible for conveying relevant data prominently on an official user interface for participants to evaluate such risks in real time;

*Regarding Discussion point 4*

f. legislators or regulators should first consider whether existing regulation can be applied to DeFi activities but where DeFi displays activities that offer novel characteristics, or combine several activities including TradFi and DeFi-type activities, it should be considered whether an "ad hoc" type regulation would offer better protection for users such as if existing requirements could prove impractical or even impossible to implement or enforce against;

*Regarding Discussion point 5*

g. the smart contract code of DeFi trading protocols be made translatable into non-technical language to ensure proper disclosure of a DeFi trading protocol's market rules and to allow regulators to read, review and approve the rules; **however**, this obligation should correspond with at least a mandatory security audit (and ideally an ongoing bug bounty program) to prevent a situation where the smart contract is translated into market rules for approval by a securities law/financial services regulator but has security vulnerabilities remaining;

*Regarding Discussion point 7*

h. the effective degree of decentralisation is a key component that should be evaluated when determining the effective degree of control that is exerted over a DAO's governance; **however** the Discussion Paper proceeds on a flawed assumption that the mere holding of a governance token equates to membership in a DAO when this is not correct – if a person has not been prominently notified, nor read or agreed to terms of membership of a DAO (if they even exist) then there can be no legal presumption that the person holds and deals with their crypto-tokens as in the nature of a governance token or as a member, which is a relevant factor in determining number of actual members versus participating members in a DAO model of governance, as well as to whom liability for any debts of the DAO can attach;

2. Without agreeing or disagreeing with the AMF, our comments on the remaining discussion point 6 are that:

a. The act of defining a regulatory scope of DeFi should focus on the idiosyncratic risks created by an autonomously functioning smart contract deployed on a permissionless blockchain. As such, an off-chain element involved in the architecture of a DeFi trading protocol should not in and of itself exclude the smart contract from falling within the

regulatory scope of DeFi. BADAS*L takes this position assuming that, overall, it would be a net positive for a smart contract design to fall within the regulatory scope of DeFi if by doing so "ad hoc" regulatory approaches could be accessed alongside a regulatory regime that is appropriate and adapted to achieve same or better regulatory outcomes than a mere TradFi approach.

b.   One of the key aims of defining a regulatory scope of DeFi should be to produce same or better regulatory outcomes for smart contract code (and any periphery code it requires to function) that can be made more secure and resilient because it is deployed on permissionless and decentralised blockchain network infrastructure. Unfortunately, there is a gap in existing IOSCO Principles which fails to deal with the principles necessary for 'securities markets' or 'financial markets' facilitated by global and decentralised blockchain networks and applications. For example, there is no specific IOSCO Principle regarding obligations or expectations upon decentralised network or application participants to act responsibly to ensure the network or application is and remains secure, resilient, available, and affordable.

This Discussion Paper pleasingly and practically acknowledges that a 'same activity, same risk, same regulation' (**same-same-same**) analysis is insufficient on its own and instead should be a starting point to identify the nuances and idiosyncrasies of the technology that produces the need for novel approaches to achieving same or better regulatory outcomes. BADAS*L has been and continues to advocate for a more appropriate guiding principle of 'similar activity, similar risk, specialised regulation, same regulatory outcome' (**similar-similar-specialised-same**), which very much aligns with the AMF approach. An illustrative example that shows the lack of utility of same-same-same and the soundness of similar-similar-specialised-same, is provided in the BADAS*L submission to IOSCO Consultation Report on Policy Recommendations for Crypto and Digital Asset Markets in July 2023.[2]

The tokenisation paradigm extends to non-financial things and increasingly decentralised blockchain and application infrastructure will be used for trusted non-financial online transactions (such as digital identity and reputation credentials, social media posts, online advertisements, emails, messaging). Where these non-financial things are represented as transferable crypto-tokens, an inevitable financial and speculative element creeps in. However, the existing IOSCO Principles and existing securities and financial services laws and frameworks are simply insufficient such that same-same-same simply cannot hold merit in these growth areas and consumers will suffer from lack of protection with the prevalence of crypto-tokens that are likely to fall between financial and non-financial.

This AMF Discussion Paper importantly lays the groundwork for safety and soundness of crypto-token activities on globally decentralised blockchain networks and applications, for activities that are primarily financial or subsequently become financial in nature.

We welcome the opportunity to discuss this submission and assist the AMF with this important work.

Yours sincerely,

Signed by:

*Joni Pirovich*

BD8A76AE148FCF1A

**Joni Pirovich**
Principal
Blockchain & Digital Assets – Services + Law (BADAS*L)

---

*Legal, strategic and policy services for web3, crypto and tokenisation projects.*

---

[2] BADAS*L submission to IOSCO's Consultation Report on Policy Recommendations for Crypto and Digital Asset Markets, available here: https://img1.wsimg.com/blobby/go/dff9c8cc-42b6-43e1-ac50-b1569230f52c/downloads/230726%20-%20Submission%20to%20IOSCO%20Consultation%20Repo.pdf?ver=1695354190110.