October 18, 2023

*Via Electronic Submission*

General Secretariat
International Organization of Securities Commissions (IOSCO)
C/ Oquendo 12
28006 Madrid
Spain

**RE: Public Comment on IOSCO's Consultation Report on Policy Recommendations for Decentralized Finance (DeFi)**

Dear General Secretariat:

The Independent Community Bankers of America ("ICBA")[1] appreciates the opportunity to provide comments to the International Organization of Securities Commissions ("IOSCO") Policy Recommendations for Decentralized Finance ("DeFi") Consultation Report ("Report").[2] ICBA and community banks have long warned about the risks posed to investors and the wider financial system by the growing shadow banking system of DeFi. We wholeheartedly support IOSCO's efforts to develop recommendations to help member jurisdictions understand DeFi arrangements and structures and realize common standards of regulatory outcomes. Equally, we strongly support IOSCO's efforts to help members identify and manage key risks, ensure clear and comprehensive disclosures, enforce applicable laws and regulations, and foster cross-border cooperation. These recommendations will provide nations with a solid foundation from which they can continue to work together to address the challenges presented by crypto assets, strengthen investor protection, and maintain the well-being of the global financial system.

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[1] The Independent Community Bankers of America® creates and promotes an environment where community banks flourish. ICBA is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education, and high-quality products and services.
With nearly 50,000 locations nationwide, community banks employ nearly 700,000 Americans and are the only physical banking presence in one in three U.S. counties. Holding $5.8 trillion in assets, $4.8 trillion in deposits, and $3.8 trillion in loans to consumers, small businesses and the agricultural community, community banks channel local deposits into the Main Streets and neighborhoods they serve, spurring job creation, fostering innovation and fueling their customers' dreams in communities throughout America. For more information, visit ICBA's website at www.icba.org.
[2] OICU-IOSCO, *Policy Recommendations for Decentralized Finance (DeFi) Consultation Report* (September 7, 2023), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD744.pdf.

## General Comments

DeFi is a collective term used to describe applications built by programmers on public blockchains that seek to replicate—or even replace—financial services and products provided by traditional entities, such as banks and exchanges. The DeFi ecosystem now encompasses hundreds of decentralized applications ("dApps") that facilitate payments, digital assets lending, complex derivatives, and much more. This ecosystem has also experienced explosive growth coupled with extreme volatility.

In late 2021, the total value of crypto assets deposited in DeFi arrangement smart contracts, otherwise known as total value locked ("TVL"), climbed to nearly $200 billion before receding to its current value of $37 billion after the failures of multiple DeFi and centralized crypto entities last year.[3] Stablecoins, a type of crypto asset that seeks to maintain a stable value, primarily exist today as a way for investors to convert fiat money into crypto assets to use throughout various DeFi applications.[4]

Community banks have a compelling interest in supporting IOSCO's work to contend with DeFi's threats because we are concerned that the next crypto crisis may spread into the traditional financial system, thus raising the potential for more acute impacts to community banks and their customers. One of the most pressing concerns related to DeFi is the growth of stablecoins. If stablecoin issuers gain access to a Federal Reserve master account and the U.S. payment system, there will be a direct channel for crypto volatility to seep into the banking system and threaten community banks.

We also believe that DeFi, such as it exists today, operates as a shadow banking system that may disintermediate community banks. If regulators fail to act quickly and decisively, the unchecked growth of DeFi could lead to unforeseen consequences for individual investors and the banking system.

IOSCO's new report presents an extraordinarily detailed and clear-eyed assessment of the full range of these risks, including the ways in which DeFi arrangements already have, or may deepen, connections with the traditional financial sector. As noted throughout the report, DeFi arrangements claim to be engaged in novel activities. Yet in reality, they simply mirror the roles and functions of traditional entities within the securities world. We agree with IOSCO's contention that DeFi arrangements are grounded in human activity—every protocol has individuals or organizations who write code, engage in governance, promote the use of the application, and perform other critical services for the application.

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[3] See https://www.defillama.com for current Total Value Locked amounts.
[4] Share of Trade Volume by Pair Denomination, https://www.theblock.co/data/crypto-markets/spot/share-of-trade-volume-by-pair-denomination



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Unfortunately, since the individuals behind most DeFi arrangements do not currently acknowledge and adhere to relevant securities laws and regulations, investors are left with few, if any, protections, and the wider financial system is increasingly exposed to cracks caused by frequent smart contract failures, crypto market manipulation, and countless hacks and exploits.

With these concerns top-of-mind, we have repeatedly argued that domestic and international regulators should be guided by the principle of "same activity, same risk, same regulatory outcome," as they seek to respond to the risks of crypto assets. Accordingly, we applaud IOSCO's aim to achieve "regulatory outcomes for investor protection and market integrity that are the same as, or consistent with, those required in traditional financial markets across IOSCO's 130 member jurisdictions," with the publication of these policy recommendations.[5]

## Securities Laws and Regulations Should Be the Foundation for Effective DeFi Policy

As we recently explained in a comment letter to the U.S. Securities and Exchange Commission ("SEC"), most crypto assets in the United States likely qualify as a security per the criteria established by the Howey Test.[6] ICBA considers SEC regulation and enforcement of the crypto sector, including DeFi, as essential to protect investors and manage threats to financial stability. Put simply, blockchains and smart contracts do not make existing securities laws and regulations obsolete. The technology should not dictate how crypto assets are regulated—it is always the activity that matters. We strongly agree with IOSCO's assessment that DeFi arrangements "mimic those of traditional financial markets."[7] Therefore, we firmly support Recommendations 1 through 8 as the foundation for a sound approach for global regulators to ensure investor protection and maintain financial stability.

In particular, ICBA and its members endorse IOSCO's call for market regulators to identify people or organizations responsible for developing and maintaining DeFi protocols in order to hold them accountable to any applicable regulatory framework. Bankers have long expressed skepticism that DeFi is now—or ever will be—truly decentralized. Moreover, DeFi protocols do not simply spring from the Internet; instead, there are individuals or groups who are responsible for every step from development to execution to promotion. Despite frequent claims to the contrary from crypto proponents, these people or entities fulfill the roles found in traditional

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[5] OICU-IOSCO, "IOSCO Establishes Global Approach to Address Risks in Decentralised Finance" (September 7, 2023), https://www.iosco.org/news/pdf/IOSCONEWS706.pdf.

[6] ICBA, "Comment Letter RE: Reopening of the Comment Period: Proposed Amendments to Exchange Act Rule 3b16 [File No. S7-02-22]" (June 13, 2023), (available at: https://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-regulators/comments-on-rule-3b-16-exchange-definition.pdf?sfvrsn=267ded17_0) (in which we argue that: "Put simply, cryptocurrencies, while novel, should not be exempt from existing legal and regulatory frameworks'… and that , 'ICBA and its member banks believe almost all cryptocurrencies primarily serve as highly volatile investments with identifiable entities responsible for managing the protocol and seeking to increase the value of any related tokens. Accordingly, we believe this activity clearly meets the criteria set forth in the landmark Supreme Court case *Securities and Exchange Commission v. W.J. Howey Co*.'"

[7] *IOSCO Policy Recommendations for Decentralized Finance*, 6.



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financial systems, such as brokers or exchanges, and they should be held accountable for failures and misdeeds.

Nevertheless, ICBA and its members are becoming more concerned about the growing interconnections across DeFi arrangements and with the traditional financial system. As we see time and time again, even a single failure can have cascading effects across different DeFi arrangements or types of crypto assets, and in turn, impact centralized crypto service providers and their users. While we are encouraged by IOSCO's efforts to highlight the spillover risks associated with specific entities with Recommendation 9, we would also appreciate additional guidance that establishes clear metrics or measurements to help regulators gauge the connections and potential risks between DeFi and the traditional financial system.

We realize that the speed of development within this sector offers new challenges to regulators as they seek to monitor and assess risks. However, new projects may soon give central bankers and market regulators better tools to study the connections between crypto asset service providers, DeFi arrangements, and the traditional financial system. Project Atlas, developed by the Bank of International Settlements with various partners, aims to deliver "data tailored to the needs of central banks and financial regulators" to help them assess the full macroeconomic impacts of DeFi and crypto exchanges.[8] Even though Project Atlas was limited to a proof-of-concept focused on the analysis of on/off chain Bitcoin transactions, it offers an example of what regulators and central banks can achieve when they collaborate.

## Conclusion

Once again, ICBA is grateful for the opportunity to provide comments in response to IOSCO's Decentralized Finance Consultation Report. While crypto assets employ some novel technologies and methodologies that may present new challenges, they do not—and cannot—exist outside the scope of regulatory authority. We believe that most crypto assets likely qualify as securities in the United States; therefore, the SEC is best positioned to serve as the lead regulator in this space.

By instituting these recommendations, global markets regulators will have the capabilities to manage the growing risks to individual investors and the financial system. ICBA and its members look forward to IOSCO's continuing work on this sector, as we consider its leadership

[8] Bank for International Settlements, "Project Atlas: Mapping the World of Decentralized Finance" (October 4, 2023), https://www.bis.org/publ/othp76.htm.



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to be critical to the successful implementation of these policies and the development of additional recommendations to address new hazards.

Please feel free to contact me at Brian.Laverdure@icba.org if you have any questions about the positions stated in this letter.

Sincerely,

/s/

Brian Laverdure, AAP
Senior Vice President, Digital Assets and Innovation Policy



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