

DECENTRALIZED FINANCE (DEFI) AND THE BIDEN ADMINISTRATION'S KEY PRIORITIES (PART II OF IV)

Last month we described the Web3 event, Cryptopia, and one of its reoccurring themes – that laws, regulations and industry standards are coming, and that's not necessarily a bad thing. Two weeks ago, we highlighted the [surging wave of data laws surrounding crypto and blockchain](#).

Most recently, this past week, the White House issued a statement confirming that "President Biden will sign an Executive Order outlining the first ever, whole-of-government approach to addressing the risks and harnessing the potential benefits of digital assets and their technologies."

The Order does not set forth specific positions that the administration wants agencies to adopt. Nor does it impose new regulations on the digital asset sector. However, the Order does identify a number of key priorities for federal agencies:

1. Protect U.S. consumers, investors and businesses
2. Protect U.S. and global financial stability and mitigate systemic risk
3. Mitigate the illicit finance and national security risks posed by the illicit use of digital assets
4. Promote U.S. leadership in technology and economic competitiveness to reinforce U.S. leadership in the global financial system
5. Promote equitable access to safe and affordable financial services
6. Support technological advances and ensure responsible development and use of digital assets

The Order also calls on the Federal Reserve to continue exploring the possibility of establishing a U.S. Central Bank Digital Currency (CBDC) – a digital form of the U.S. dollar – which would undoubtedly lead to new laws for decentralized finance (DeFi).

DEFI DEFINED

DeFi is a broad term that subsumes a wide variety of applications, including blockchain technologies designed to eliminate intermediaries (i.e., banks). DeFi

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allows “several entities to hold a copy of a history of transactions, meaning it isn’t controlled by a single, central source.”

For cryptocurrencies, DeFi accelerates transactions and increases efficiency. But DeFi also presents regulatory challenges. According to the Securities and Exchange Commission (SEC), there are two primary hurdles for investment markets and consumer protection, specifically, lack of transparency and pseudonymity.

[Lack of Transparency](#)

While often celebrated for being ‘transparent,’ the SEC contends that DeFi favors professional investors. “Much of DeFi is funded by venture capital and other professional investors” who have created higher-returning structural conditions. In addition, the SEC contends that the underlying blockchain technology is so complex it creates barriers for retail investors.

[Pseudonymity](#)

Similarly, the secrecy of trader identities poses risks to the integrity of asset pricing and DeFi trading, especially when concerning manipulation under pseudonymity. While transactions are open for anyone to view through public blockchains, there is no concrete system for ensuring the validity or identity of traders, creating a higher propensity for manipulation.

Arguably, pseudonymity has the potential to devolve DeFi into a dishonest system by which manipulative trading tactics can flourish and disrupt the validity of crypto trading practices. In traditional markets, regulations surrounding manipulative trading are well established. However, due to pseudonymity, regulations are difficult to enforce for DeFi, and cybersecurity incidents can be severe. For example, in November 2020, cyber criminals stole \$20 million of users’ funds by exploiting a vulnerability within a smart contract. In September 2021, cyber criminals were able to leverage a bug in a codebase and steal 277 bitcoins.

Regulatory officials recognize the risks associated with DeFi and are somewhat eager to address these risks *via* targeted regulation to safeguard personal and aggregate finances. Upticks in cyberattacks have sounded the alarm for increased attention to the potential detriments DeFi poses on consumers and the structural integrity of blockchain technology.

In addressing attitudes toward DeFi, blockchain, and potential risks to financial markets and institutions, Executive Director of the Association of Certified Anti-Money Laundering Specialists, Rick McDonell, said, “Regulatory officials have made two things clear: they are supportive of the benefits that blockchain technology can confer on end-users, but they are not ready to trust the sector’s



ability to manage its financial-crime risks.”

For further information about the intersection between data innovation, privacy, security and legal obligations for DeFi, please contact the authoring attorneys at Armstrong Teasdale, or sign up/download the materials for the webinar on March 16, 2022, titled “*The Intersection of Blockchain, Crypto and DeFi with Data Innovation, Privacy, and Security.*”