

ACPR PUBLISHES A CONSULTATION PAPER AS FRANCE LEADS FROM THE FRONT IN THE DEBATE ON THE SUPERVISION AND REGULATION OF DEFI

Although Europe is still waiting for the new Markets in Crypto-assets Regulation ("**MiCA**") to be formally approved by the Council of the EU,¹ focus is already turning to the next big question: should "Decentralised finance" (also referred to as "DeFi") be regulated and supervised, and if so, how?

Decentralised finance or DeFi refers to crypto-asset services that are similar to financial services and are carried out without the intervention of an intermediary. Its growth has been fuelled by the development of public blockchains, smart contracts and decentralised applications (DApps).

The main activity in the DeFi sector is collateralised lending, which allows counterparties to bet on the future upward or downward evolution of the value of crypto-assets, but there are many other use cases including derivatives on traditional financial assets (where a crypto-asset represents the value of a real financial asset held as collateral, the price of which it follows), derivatives on crypto-assets and crowdfunding.

Other, more complex use cases demonstrate the difficulties of establishing how to regulate this space. For example, DeFi can also be used for (a) uncollateralised loans (also known as flash loans) whereby users borrow crypto assets without collateral and repay the loan within the same blockchain transaction, (b) staking/liquid staking (which relates to the mechanism used to validate transactions on proof of stake (PoS) blockchain), (c) token swaps on decentralised exchanges (DEXes) and (d) yield farming, whereby crypto assets are locked in a smart contract and used (or "farmed") by a counterparty in exchange for a given yield.

The need to regulate DeFi: an international debate

MiCA provides for a report to be drawn up by the European Commission within 18 months of its entry into force, assessing, among other things, the value of and procedures attached to a European regulation on disintermediated finance.

Key issues

- The ACPR has launched a consultation in relation to how DeFi should be supervised and regulated
- The ACPR analyses the risks and potential regulatory solutions for DeFi on a layer-by-layer basis: (i) the blockchain infrastructure layer, (ii) the services application layer and (iii) the user interface layer
- The consultation fits into a wider international debate, with it widely recognised that the benefits of DeFi are counterbalanced by a number of risks which may need to be addressed through regulation

¹ The definitive text of MiCA been voted by the EU Parliament on 20 April 2023 and is expected to be approved by the EU Council in Q2 2023. It will enter into force 20 days after its publication in the Official Journal. The provisions on asset-referenced tokens and e-money tokens will apply from 12 months after entry into force, expected to be spring 2024. Other provisions of MiCA will apply from 18 months after entry into force (i.e. in the second half of 2024).

As was the case for MiCA, the decision to regulate DeFi will only be taken at the end of a lengthy sounding process by the European Commission. The sounding process has indeed already begun, with an [report on DeFi](#) submitted to the European Commission at its request in June 2022. The report provided a balanced overview of the risks and rewards associated with DeFi and called for a coordinated public effort to promote the growth of DeFi whilst ensuring the respect of the public policy goals of financial stability, economic inclusion, market integrity and consumer protection.

The European Commission will also look at empirical data and indeed in October 2022 it launched a [tender for a pilot project](#) to develop, deploy and test a technological solution for embedded supervision of DeFi activity. The project will test the technical feasibility of monitoring real-time DeFi activity by gathering transaction data directly from the Ethereum blockchain (the biggest settlement platform of DeFi protocols).

There is also a wider context to the European Commission's scrutiny of DeFi, with the international financial community equally focusing on the DeFi sector. The Bank for International Settlements wrote an article on the [risks related to DeFi](#) in December 2021, the OECD have published a number of papers on DeFi, most recently in [December 2022](#), and in February 2023, the Financial Stability Board published a paper on [the financial stability risks of decentralised finance](#).

Developments in France

As for the EU Pilot Regime² and MiCA, for which the French ecosystem was extremely active in the promulgation, revision and implementation/marketing of such regulations, there has already been a lot of commentary on DeFi in France.

The Banque de France, proving itself to be the most innovative and tech-focused central bank in Europe, has already communicated its views on DeFi. Whilst, rightly, it believes that DeFi remains on the margins for now and is far from playing a dominant role in the financial system, it has stressed the need to remain 'vigilant' as to its future evolution. It has called for a clear, fair and balanced regulatory framework for the regulation of crypto assets ecosystem (which includes actors looking at DeFi) and raised concerns about the shift in the governance model seen in DeFi whereby trusted intermediaries (including the central banks and supervisors) are replaced by "trusted" code³ and innovative governance arrangements through decentralised autonomous organisations (DAO).

The French financial markets authority, the *Autorité des marchés financiers* (the "AMF") has also been keenly aware to the opportunities and challenges related to digital finance and stated as early as 2020, albeit in the context of security tokens, that it was concerned about the use of public blockchains which, being based on a decentralised consensus, do not allow the identification of an operations manager.⁴

² Under Regulation (EU) 2022/858 of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology (the "EU Pilot Regime"), live from 23 March 2023, the operators of DLT Market infrastructures will be given the opportunity under the EU Pilot Regime to experiment with the use of DLT in issuance and post-trade processes, free from certain regulatory constraints.

³ Denis Beau, First Deputy Governor, [speech](#) at the European and American Chamber of Commerce Event (January 2023, New York)

⁴ [Review and analysis of the application of financial regulations to security tokens](#), AMF (February 2020)

The wider tech ecosystem and financial industry in France is also engaged on the issue of DeFi regulation. The Legal High Committee of Financial Markets of Paris ("**HCJP**"), composed of lawyers, academics and other qualified individuals in France, is currently working on a paper to consider the legal status of DAOs from the standpoint of French law. The HCJP is expected to deliver its conclusions in the third quarter of 2023.

The ACPR paper

In this context, in April 2023, the Fintech-Innovation Hub of the *Autorité de contrôle prudentiel et de résolution* the French Prudential Supervisory and Resolution Authority or the "**ACPR**") has published a discussion paper (in parallel with a consultation) which sets out the main use cases of DeFi, its potential and its limitations (including the risks associated with it). In their paper, the ACPR note their preference for the term "disintermediated finance", given the high level of concentration that characterises the DeFi ecosystem (for example, governance tokens used to make governance decisions on a blockchain protocol are sometimes concentrated in the hands of founders, developers and funders), as well as the fact that governance of its applications is sometimes highly centralised. For the sake of simplicity we will continue to refer to "decentralised finance" and "DeFi" in this client briefing.

The ACPR note that the difficulty of regulating DeFi is that financial regulation is meant to be risk-based ("same activity, same risks, same rules"). It can be difficult to assess the risks of DeFi given that the system is designed to eliminate the usual intermediaries in the financial industry who carry out key operations and manage associated risks such as banks, insurance companies and clearing houses. The bulk of financial regulation indeed focuses on the activities of these intermediaries.

However, the ACPR is not in favour of the imposition of a "monolithic" block of DeFi regulation. It argues in favour of a more nuanced approach, sometimes adapting financial legislation, sometimes adapting non-financing legislation (such as those governing product safety in the European Union) and other times introducing new laws to identify responsible parties (thus regulating through "recentralisation").

The ACPR also astutely notes that any regulation will need to be adapted to an industry that is constantly changing. Any regulatory solutions will depend upon the development of DeFi in the next few years, both in terms of the size and its relative importance, the services it enables as well as technical trends such as industry preference for certain technologies or features (including for centralisation of certain functionalities or roles).

Non-exhaustive summary of the ACPR's layer-by-layer approach to regulation

1. The blockchain infrastructure layer

Definition:	Blockchain infrastructure comprises a distributed ledger over a set of nodes, which agree on its content via consensus algorithms.
Risks:	The ACPR identifies a number of risks associated with infrastructure, such as (i) network congestion which can cause transactions to fail, impact withdrawals in crypto-assets or prevent updates and (ii) protocol misuse (also known as zero-day vulnerabilities) which includes 51% attacks (which occur when a group of malicious users holds more than 50% of validation capabilities) and attacks on bridges between blockchains.

Potential regulatory solution(s):	<p>Among the potential regulatory solutions proposed by the ACPR are the following:</p> <ul style="list-style-type: none"> ○ in relation to public blockchains, regulating them through minimum standards (for example in relation to security or the degree of concentration of validation capacities); and ○ switching purely financial functions to private blockchains operated by trusted players who fall under a specific supervisory framework.
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2. *The "services" application layer*

Definition:	Decentralised applications (DApps) or DeFi protocols are stacks of smart contracts built on the blockchain infrastructure, each corresponding to specific use cases. The "application layer" also refers to certain centralised applications such as centralised exchange platforms and oracles (entities that transfer information from the real world to smart contracts).
Risks:	The risks that the ACPR identifies in the services layer include (i) intentional or unintentional flaws in the computer code behind smart contracts, (ii) data reliability and (iii) the immutability of blockchain exacerbating errors or fraud by oracles.
Potential regulatory solution(s):	<p>Among the potential regulatory solutions proposed by the ACPR are the following:</p> <ul style="list-style-type: none"> ○ auditing the code behind smart contracts or testing them with formal proof mechanisms; ○ certifying the computer code used in DeFi applications according to standards either set by market participants or public authorities. The certification could cover matters such as the security of the computer code, the nature of the provided service and governance issues and could be (a) withdrawable at any time, (b) granted for a limited period of time and (c) renewed after any significant change to the computer code; ○ linked to the above, discouraging or prohibiting interactions with uncertificated smart contracts; ○ introducing a decentralised oracle certification system, with a particular focus on the consensus mechanism leading to the final result (i.e. responsible for the weighting of various data sources); ○ introducing a circuit breaker on the data supply from oracles; and ○ injecting data into the DeFi ecosystem through centralised entities or establishing a framework dedicated to the supervision of data providers (centralised or decentralised) by public authorities.

3. *The user interface layer*

Definition:	Interfaces allow users to interact more easily with the decentralised applications. Interfaces can play an aggregator role (connecting multiple applications and protocols) and crypto-asset wallets are one example of an interface which allows a user to connect with a blockchain (contrary to what the name suggests, crypto-assets are not stored in the crypto-asset wallets themselves). The ACPR notes that the bulk of the general public's interactions with DeFi protocols currently takes place
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	through intermediaries such as (i) centralised providers of crypto asset services and (ii) front-end web interfaces of decentralised protocols.
Risks:	The ACPR picks out a number of issues with the interface layer, not all of which are technological. Concerns are raised as to the high risks of capital loss and complexity of the financial products seen in the DeFi world for retail investors. Emphasis is placed upon the systemic weakness inherent in DeFi which is the price volatility of the crypto assets that are traded therein. It is made clear that even automated liquidation mechanisms introduced through smart contracts can increase the vulnerabilities of the system (in a similar manner to which Layer 1 and Layer 2 solutions, designed to resolve weaknesses with blockchain infrastructures, can increase overall vulnerability). ⁵
Potential regulatory solution(s):	<p>Among the potential regulatory solutions proposed by the ACPR are the following:</p> <ul style="list-style-type: none"> ○ requiring the identification (and potentially supervision) of those responsible for providing smart contracts (to enable a minimum level of control required for their correction or termination), even where "decentralised" models have been adopted; ○ imposing a duty of care and a duty of advice on DeFi intermediaries and supervision of their risk-taking to limit bankruptcies and contagion effects; ○ extending the scope of the provisions of MiCA concerning "crypto-asset service providers" (CASPs) to DeFi intermediaries; ○ introduction a regulation on DeFi intermediaries governing (i) transparency on underlying crypto assets and (ii) Know-your-client (KYC) mechanisms; ○ making providers of access to DeFi subject to rules of good conduct and imposing prudential requirements upon them; ○ requiring DeFi intermediaries to restrict the ability of users to invest in complex products should they not have sufficient experience and expertise; and ○ imposing a maximum leverage effect on users.

The deadline for responding to questions in the ACPR consultation is 19 May 2023. The hope is that the ACPR consultation, along with other initiatives in France in the coming year, will lead to the development of consensus as to the best way forward with regards to the regulation of the DeFi industry. A clearer path towards legal certainty would provide a much-needed boost to the DeFi industry, still recovering from the May 2022 crash of Terra /Luna, and the French tech ecosystem.

⁵ Layer 1 and Layer 2 solutions are both scaling solutions for blockchains. Layer 1 solutions seek to either increase the validation power of blockchain infrastructures or fragment a blockchain into several smaller and more flexible blockchains, called shards. Layer 2 is a model in which parts of the transactions are processed off-chain, recording only the minimum amount of information in the main chain.

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