



# BLOCK START

## D5.7: Policy Recommendations - 1<sup>st</sup> version

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List of Abbreviations and Acronyms	
<b>DLT</b>	Distributed Ledger Technology
<b>DeFi</b>	Decentralized Finance
<b>CeFi</b>	Centralized Finance
<b>Q</b>	Question
<b>M</b>	Million
<b>SME</b>	Small and Medium-sized Enterprise
<b>AML</b>	Anti-Money Laundering
<b>KYC</b>	Know Your Customer
<b>EC</b>	European Commission
<b>MiCA</b>	Markets in Crypto-assets

# 1. Introduction

The rise of blockchain technology-based solutions has presented a lot of opportunities for making processes more trustworthy, safe, and potentially more effective. However, alongside the promises of the technology that aimed to revolutionize the current status quo, came a lot of challenges. How do you regulate applications that pose fundamental challenges to the way you do business? Can current institutions and instruments be adapted for use or does it require a completely different framework?

As part of BlockStart activities, we aim to challenge the policy makers and regulators by inviting them to energizing discussions on the legislative and regulatory approaches concerning blockchain technology application.

The exercise began in Lithuania, which has been at the forefront of regulatory debate. The central bank of Lithuania was the first one to issue regulations regarding security tokens, has been proactively engaged in discussions with the blockchain community, has set up the regulatory sandbox to understand where the technology is going, and recently has issued a digital coin. This proactive approach that emphasizes collaboration with innovators in ensuring timely and relevant application of new regulatory measures could potentially be an example to follow across Europe.

Currently we are seeing a surge in decentralized finance (DeFi) applications, a sector that is continuously growing and over USD 8bn<sup>1</sup> in total assets are currently locked into the ecosystem's various platforms. DeFi offers enormous potential in the field of trading cryptocurrencies. New upcoming solutions could even replace the existing central depositories and other intermediaries and increase efficiency and speed.

DeFi is particularly relevant to Lithuania—a growing fintech hub in Europe. The emerging use of decentralized financial technologies may have implications for the effectiveness and enforceability of current regulatory frameworks, particularly when the current execution of supervisory activities focuses on the presence of centralized decision-making entities (e.g. financial intermediaries). The inability to regulate this new field might indeed slow down the pace of technological and business development. Therefore, given the need to better understand the challenges relating to DeFi regulation and its relevance for Lithuania, it is the main focus of this deliverable.

The analysis and insights presented in this document have been collected through a combination of desk research, conversations with the regulators and through a policy workshop organized by BlockStart team. The information collected during the project will be used extensively to facilitate the development of a compelling regulatory framework and government support activities to SMEs.

## 2. Overview of the legislative context

Understanding the regulatory landscape across all applicable jurisdictions and structuring arrangements accordingly is an essential step for anyone involved in DeFi activities. Getting it wrong can have not just financial implications but also criminal ones. Founders, developers, issuers,

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<sup>1</sup> <https://cryptonews.com/exclusives/the-defi-sector-is-breaking-the-law-it-s-time-to-act-7630.htm>

promoters, operators, providers and users all bear these risks, which may arise regardless of whether operation or governance is centralized or decentralized.

Regulators are trying to pay close attention to this area, according to the guidelines of the Financial Stability Board (<https://www.fsb.org/wp-content/uploads/P060619.pdf>) and the Board of the International Organization of Securities Commissions (<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD649.pdf>). These two documents provide principles and methodology that are expected to be guidance tools for the issues, risks and other key considerations that come with DeFi activities.

Notably, the European Commission has recently proposed a comprehensive new framework (<https://ec.europa.eu/transparency/regdoc/rep/1/2020/EN/COM-2020-593-F1-EN-MAIN-PART-1.PDF>) for the regulation of markets in crypto-assets, which is likely to have significant implications for the DeFi market.

In each applicable jurisdiction, there will be a number of regulatory issues to consider. This includes the regulatory characterisation of the DeFi platform and the activities that are conducted. Certain obligations, particularly around anti-money, consumer protection, data protection and tax requirements are expected to be supervised according to general legislative framework for DeFi, which hasn't been reached yet.

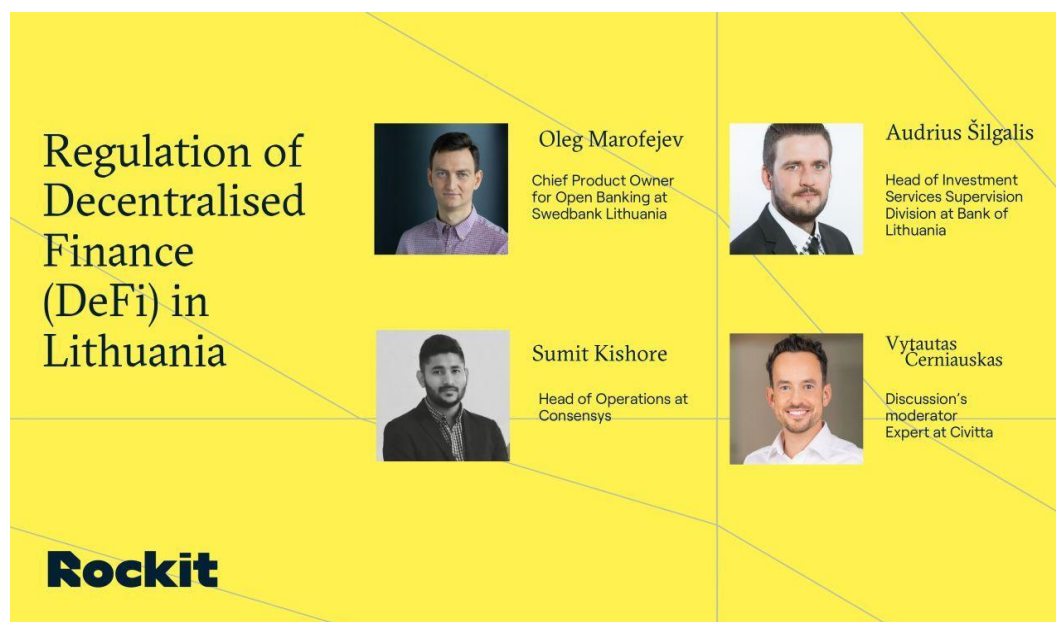
### 3. Gathering input from stakeholders: discussion on regulation of decentralized finance (DeFi)

In order to collect feedback from key financial industry players, CIVITTA initiated a panel discussion "Regulation of Decentralized Finance (DeFi)." The event was co-organized with ROCKIT (<https://www.rockitvilnius.com/>), which is the prime space in Lithuania where top fintech innovators, creators and founders build the future of financial technologies. ROCKIT is a strong community featuring mentors, regular industry events and hosting acceleration programs. Joint forces of CIVITTA's expertise and ROCKIT community helped achieve higher engagement of ecosystem members.

The panel discussion took place on 12 November 2020 and was broadcasted live via Facebook ([https://www.facebook.com/watch/live/?v=2731782303702519&ref=watch\\_permalink](https://www.facebook.com/watch/live/?v=2731782303702519&ref=watch_permalink)) and YouTube (<https://www.youtube.com/watch?v=V3JzNJzTxFA>). It was led by Vytautas Černiauskas, expert at CIVITTA and included the following professionals:

- Audrius Šilgalis, Head of Investment Services of Bank of Lithuania,
- Oleg Marofejev, Chief Product Owner for Open Banking of Swedbank Lithuania, and
- Sumit Kishore, Head of Operations at Consensys.

Figure 1. The discussion panelists



The objective of the panel discussion was to articulate the emerging trends on the market, focusing on the relevant regulatory instruments that are already in place and areas where regulation is missing. The panelists were challenged to discuss the improvements needed and rethink whether the current framework that is in place to regulate the decentralized market needs to be re-assessed.

### 3.1. Discussion overview

The discussion started with the overview of the DeFi and how it is complementing and challenging the financial sector. Mr Oleg Marofejev of Swedbank, who has over 15 years of experience working in traditional bank focusing on digital development projects, gave his perspective on the main innovation trends arising from the technology and provided an overview of the actions and initiatives that traditional banks take in order to keep up with fast-paced technologies such as blockchain. According to Mr Marofejev, in order to keep up with the new trends, the researches and key studies are being conducted to fully understand what's the position of the traditional bank in the financial innovation world and how to act on certain changes to maintain competitive position.

Audrius Šilgalis of the Bank of Lithuania, the institution which is responsible for the development of a fintech-conducive regulatory and supervisory ecosystem, provided the background for the discussion by defining what financial innovation actually means. Bank of Lithuanian representative has a strong background in financial innovation activities and is a member of Financial Innovation Standing Committee (FISC), also approaching 10 years of experience at Bank of Lithuania specialising in investment services. Mr Šilgalis continued discussion by describing the main challenges facing the regulator and the need to balance the flow of innovation and ensure customer protection. Mr Šilgalis noted that there is a lack of the central entity to explain the regulator requirements and singled out AML for having a lot of applicable regulation.

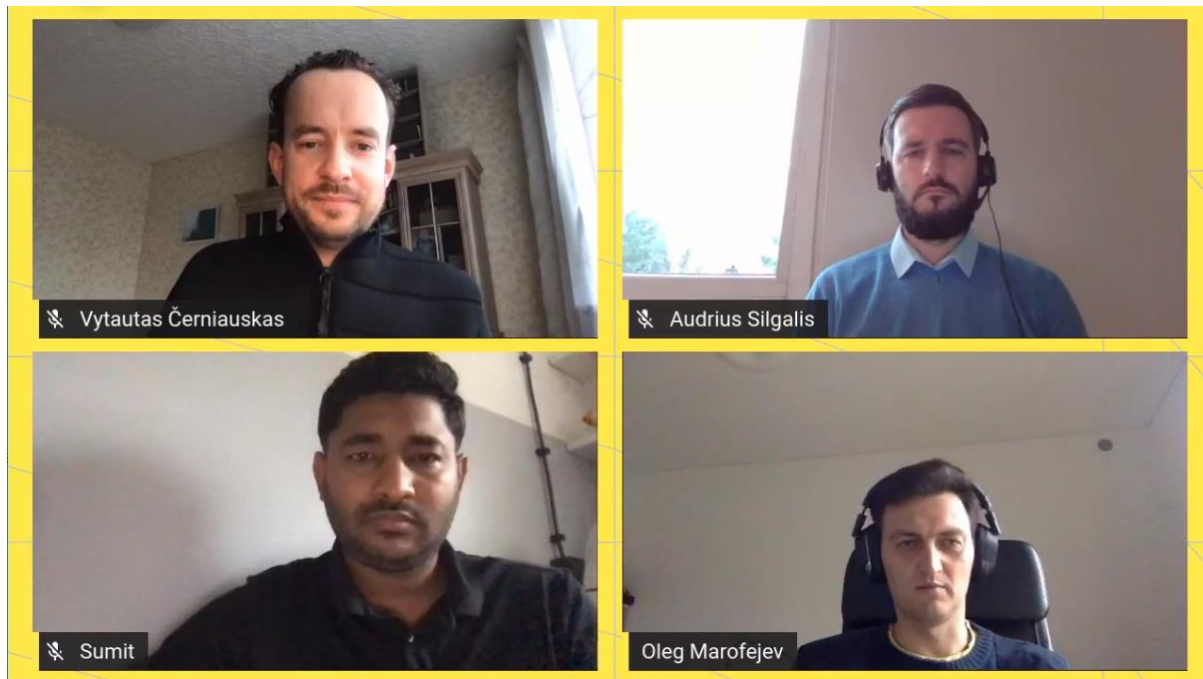
Startup ecosystem representative Sumit Kishore from Consensus, a blockchain solutions provider, highlighted the issues in DeFi and other similar innovations in the fintech area that innovators face from a regulatory point of view today, such as missing clarity on the regulatory framework that the

companies have to follow. He also expressed the need of compliance tools that would help fulfil regulatory requirements. Mr Kishore, who is an active DeFi startup representative, keynote speaker in various international events highlights his insights in compliance as his specialization.

In the discussion, the need to ensure customer protection and avoid privacy breaches was highlighted.

The participation of a legislator, traditional financial institution and a blockchain innovator ensured a complementarity and inclusiveness of views, making sure that regulator and innovators angles were presented.

*Figure 2. Screenshot of the live event*



### 3.2. Conclusions and insights

While the discussion touched upon a variety of many issues, the following key problems can be singled out:

- The current regulatory tools are not suited for many DeFi solutions.
- There is a strong need to ensure prevention of money laundering, financial crimes and financing of terrorism as well as and having proper KYC procedures, the need to understand who you are working with.
- Ensuring security, consumer trust and consumer protection and protection of their data are key priorities of the regulation; the rights of customers need to be ensured so they can fully benefit from the DeFi solutions.
- Lack of central authority and regular interaction between the innovators and the regulators. Supervisors need to have contact with the DeFi companies to help them understand and implement regulatory requirements and who, on their end, can explain the solutions and logic behind the models they use.



- Lack of clearly defined regulatory framework and guidelines as the supervisory authorities are still learning and preparing regulation.
- From a regulation perspective, it is very difficult to understand how a regulator could apply regulatory powers and supervisory capability to a technology protocol that enables lending against assets without a lender (i.e. based almost entirely on an aggregate market value of assets mediated by way of a smart contract only).
- Other enquiries into the subject matter emphasize that a more decentralized financial system may reinforce the importance of an activity-based approach to regulation, particularly where it delivers financial services that are difficult to link to specific entities and/or jurisdictions. Certain technologies may also challenge the technology-neutral approach to regulation taken by some authorities.

Other inquiries into the regulation of DeFi also highlight the need to approach the risks in DeFi in newer ways.<sup>2</sup> The concerns that arise, when seeking to define the regulated activity and the regulated person, consider questions how to regulate against negative outcomes when there is no actual person responsible. This is going to require regulation on a more exclusive basis, for instance, responding to the risk of market harm to the consumers. This will present legislative challenges for the regulators unless they know the best practices of how to protect consumers. The other part of this online business will certainly hold other threats such as territorial scope and enforcement.

### 3.3. Recommendations regarding DeFi regulation

In order to make the best use of the technology we need to either change the existing laws or create exceptions that address the specifics of DeFi.

DeFi companies can be regulated and provide safe and secure services to everyone. They should ensure due diligence, consumer protection, and focus on good user experience (for example, what happens when users lose access to their wallets or are sharing their wallets). Many companies coming to the DeFi space are not completely aware of the regulatory framework they have to follow. There are already solutions available on the market that allow DeFi companies to meet the regulatory requirements and best practices and keep users safe and further education of such existing solutions is necessary.

One way to go is to gradually apply to the DeFi industry the existing framework in a lighter perspective, which is already used to regulate the traditional centralized financial market players. While the traditional players complain of the heavy regulation and resources needed to ensure compliance, it ensures the protection of rights and interests of the service beneficiaries and other parties involved.

Another way is to implement regulation in a way different from the traditional method—to bring regulation from users, from the bottom up. The concept of decentralisation and the power of community could be used. There are enthusiasts who understand regulatory needs and could come up with either rules and regulations or define and structure problems. Maybe those central supervisory entities could have access to the general ledger and get information from there. When

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<sup>2</sup> <https://www.emergingpayments.org/article/regulation-of-decentralised-finance-defi-in-europe/>

the problems are defined and specified by the community, regulatory experts from existing supervisory bodies could help in structuring solutions and then the technical community could implement them. This could be a much more efficient approach than the system currently used to regulate CeFi. Central authorities could also help in some unclear cases when specialty knowledge is needed.

The Bank of Lithuania was the first in Europe and one of the first in the World to create a blockchain sandbox for newcomer companies which want to develop and test blockchain-based solutions in a regulated market. This also helps the regulator to learn and understand what regulations could and should be applied to this kind of solutions. In general, the supervisory bodies need to think about new ways to regulate these innovations in crypto and blockchain space.

EC has presented new regulatory proposals of crypto assets (MiCA) to support innovation and to add consumer protection and a pilot regime for market infrastructures based on DLT. The purpose is to develop a secondary market for tokenized financial instruments and to encourage other innovations in this field. Market players and regulators should actively use existing consultation channels to provide their questions and suggestions to the EC in order to improve the proposals.

A strong recommendation for players creating innovative solutions is to not be afraid of regulators and talk to them directly explaining the models and concepts they are developing. In certain cases supervisory bodies we could provide them with suggestions or recommendations and even help in making sure there are no legal grey areas. It is better to be regulated than to work outside the regulation and to be afraid of what happens if something goes wrong.

*Figure 3. Post-event quotation shared on social media channels*



## 4. Event reach

29 participants joined the live event streamed on Facebook and YouTube. The recording was later viewed by approximately 2000 people (see Figure 4 and Figure 5).

Figure 4. Key metrics of Facebook live event performance

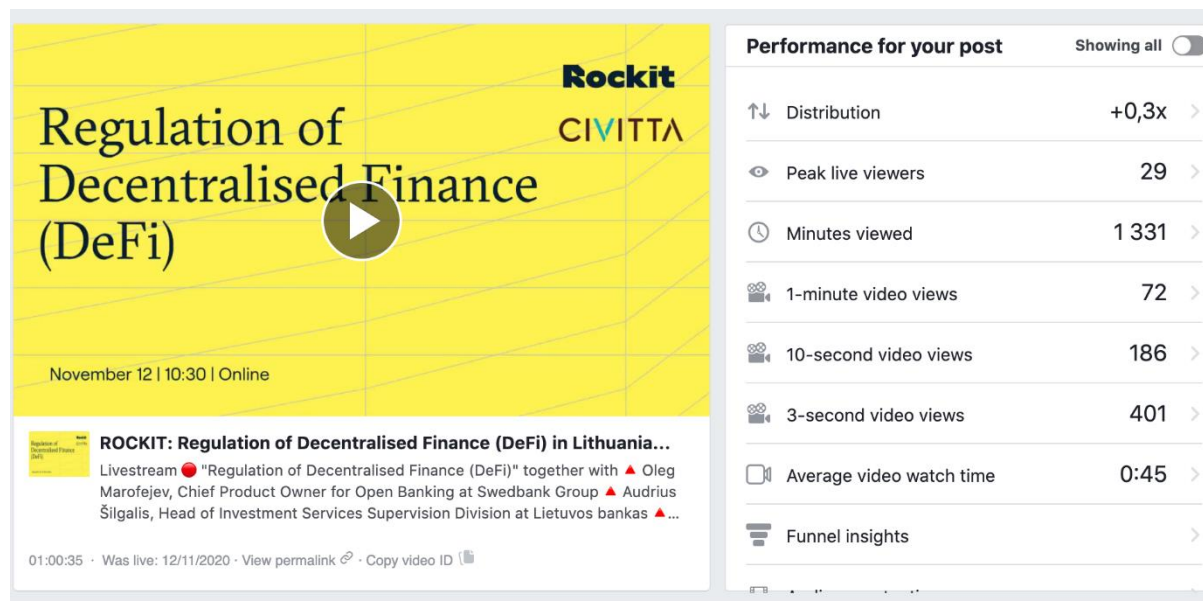
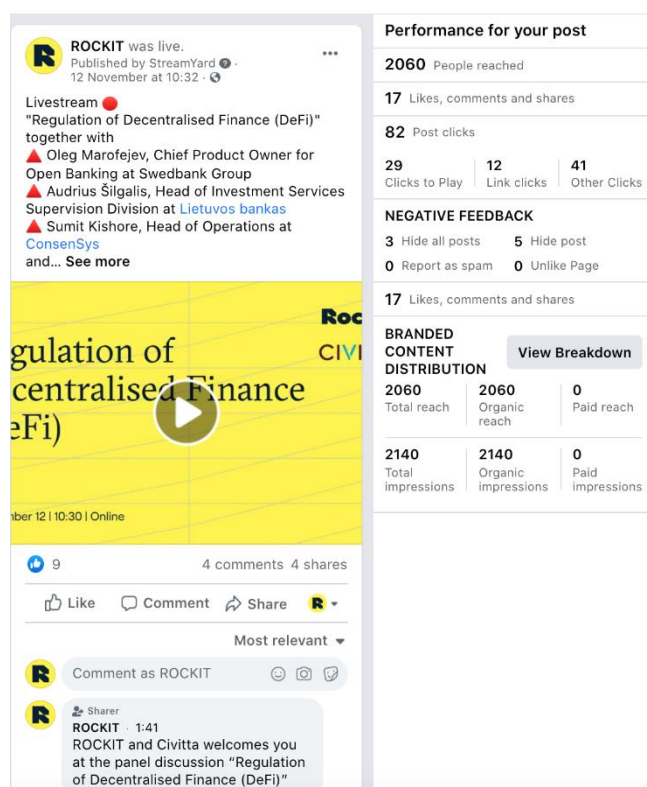


Figure 5. Screenshot of Facebook live event reach



The ecosystem representatives, according to the event survey, represented intermediaries from the following types of organizations:

- SME Associations or other support organizations (accelerator, incubator, etc.)
- Scientific communities (Higher Education, Research, etc)

- National/European public institutions (EC, innovation agency, etc.)
- Industries/Corporates
- Investors
- Civil society (NGOs and other non-profits)
- General audience

The panel discussion can be found online at the following links:

- Facebook:  
[https://www.facebook.com/watch/live/?v=2731782303702519&ref=watch\\_permalink](https://www.facebook.com/watch/live/?v=2731782303702519&ref=watch_permalink)
- Youtube: <https://www.youtube.com/watch?v=V3JzNJzTxFA>

The next discussions will be organized in other locations and the feedback and insights collected will feed the upcoming deliverables, as well as be presented in the final project conference scheduled to take place in Brussels, in February 2022.