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Budding Decentralized Finance Industry Comes With Risks

By Ali Abugheida (August 21, 2020)


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The sudden rise of Compound Labs Inc.'s COMP governance token in recent months pushed decentralized finance into the headlines, raising the profile of blockchain-based finance systems to a more mainstream audience.[1]

This article provides a short primer on decentralized finance and discusses some of the key legal risks facing the industry.

What is decentralized finance?

Decentralized finance is a catchall term often used to refer to the creation of alternative finance systems built on blockchain technology. They are decentralized, transparent and accessible to anyone in the world with an internet connection.

Compound is one example of a decentralized finance protocol built on the Ethereum blockchain — the second largest cryptocurrency by market cap behind Bitcoin. The Compound protocol establishes money markets that use algorithms to set interest rates based on supply and demand. Third parties can create decentralized finance applications that interface with the protocol.

Decentralized finance applications allow users to lend, earn interest, borrow, exchange or even go long or short on cryptocurrencies. In other words, decentralized finance applications provide users with access to financial products and services akin to those available in the traditional financial system. The difference, at least in theory, is that these services are provided in a decentralized, transparent and accessible way.

Decentralized finance applications and the ability to provide financial services and products similar to those offered by the traditional financial system is what distinguishes decentralized finance, as a concept, from cryptocurrencies standing alone. For example, cryptocurrencies, on their own, do not provide for lending, borrowing or savings functions.

Why is decentralized finance suddenly so hot?

In mid-June, the Compound project launched the COMP governance token, which is an asset that allows its holders to debate, propose and vote on changes to the Compound protocol. Compound awards COMP tokens to its users based on their lending and borrowing activities, and only those holders may participate in Compound's governance, including decisions about how it might be changed in the future.

The token's price surged by approximately 250% after launch, giving it a market value of approximately $2 billion. Some of the initial enthusiasm has faded, but the sudden surge helped fuel a "yield farming" craze, which refers to the practice of using decentralized finance protocols and applications as leverage to generate higher than usual rates of return.[2]

A simple version of yield farming would be a user lending cryptocurrency to the Compound protocol solely to generate COMP governance tokens. The user could earn interest on the cryptocurrency it was lending and earn COMP tokens based on that lending activity.

There have been reports and speculation that more traditional financial institutions, including certain large global banks, will soon provide cryptocurrency-related finance services.[3] All of this follows significant developments in 2019, including efforts to offer a cryptocurrency debit card, and an announcement by a major bank regarding its own efforts to create a cryptocurrency.[4]

But not all decentralized finance news has been positive. In February, bZeroX LLC's decentralized finance protocol, bzx, suffered two attacks in which flash loans were used to manipulate market prices, netting the attackers approximately $1 million.[5]

Flash loans provide borrowers with instant liquidity without the need for collateral as the loan must be paid back in the same transaction; if the borrower is unable to pay back the loan the entire transaction is rolled back. Since February, a number of other DeFi-related attacks and incidents have been reported. At least one of these instances led to the filing of a class action in California.[6]

What types of decentralized finance applications are currently available?

The decentralized finance ecosystem has rapidly evolved and now supports margin trading, lending, borrowing, international money transmission, the creation of synthetic assets, flash loans and high-yield savings accounts. By lowering barriers to entry, reducing or eliminating fees, and providing services to anyone with an internet connection, decentralized finance has arguably given more people more products and functionality than the traditional finance system.

For example, high-yield savings accounts from traditional financial institutions often come with minimum balance requirements and other limitations; decentralized finance applications tend not to impose such requirements.

What legal risks does decentralized finance face?

Decentralized finance will have to navigate numerous legal obstacles beyond the well-covered practical and technological obstacles it faces in challenging the traditional financial system, including the following.

Regulation

Federal and state regulators are still struggling to fit cryptocurrencies and related businesses into their existing regulatory enforcement structures and, for the most part, have not created new structures for them. For example, certain states (including Connecticut, Vermont and Virginia) require cryptocurrency exchanges to register and become licensed as money transmitters under state law.[7]

Numerous other states have taken no formal position regarding the need to license under existing law, but appear to have plans to license all digital currency businesses. For example, in February 2019, the California Legislature introduced Assembly Bill 1489, which did not pass that session, but would have generally prohibited engaging in virtual currency business activity, or holding oneself out as a virtual currency business, unless licensed or registered with the Department of Business Oversight.[8]

New York has arguably gone the furthest, issuing regulations in an effort to create a more robust licensing and regulatory BitLicense framework that applies to different forms of virtual currency businesses, not just money transmission, but it has issued relatively few licenses in the five years since its inception.[9]

This uncertainty leaves cryptocurrency businesses without definitive guidance on what they need to do to comply with applicable law. This, in turn, leaves them vulnerable to regulatory enforcement proceedings.

Decentralized finance proliferation heightens this risk. In addition to anti-money-laundering, money transmitter and other laws that may have been applicable to cryptocurrency businesses in the past, newer decentralized finance applications venture into other areas of regulation, most notably lending.

State and federal lending rules and licensing requirements can be complex, burdensome and simply difficult to keep track of. Many decentralized finance companies, absent comprehensive licensing requirements, will be hard pressed to figure out to what extent they must comply with state and federal lending laws and, if so, which ones.

Class Action Risk

State and federal regulators and legislatures have not created a universal regulatory structure for regulation of cryptocurrency businesses, but that has not stopped individuals and businesses from seeking relief from the courts when they perceive that they have been wronged. In 2019, numerous class actions were filed against cryptocurrency business and, thus far, 2020 has seen more of the same.

For example, classifying cryptocurrencies as something other than securities may expose cryptocurrency businesses to state unfair, deceptive, or abusive acts or practice laws, which provide powerful consumer protections.[10] These types of claims, when asserted on a class basis, can present significant risk to any business.

Patent Litigation

Traditional financial institutions are increasingly investing in blockchain technology, and seeking to patent the technology that they invent.[11] While this has not yet led to a spike of patent litigation, the stage is being set. If decentralized finance applications reach mainstream use, patent litigation would likely be inevitable as those that ultimately succeed will try to defend their positions with patents and those that lose out will try to extract value from the patents they obtained earlier.

Patent litigation could also push out lower-capitalized decentralized finance companies that cannot afford the costs.

Conclusion

Decentralized finance has the potential to meaningfully change how consumers and businesses obtain and provide financial services. At the same time, as decentralized finance expands, the legal risks and challenges are likely to grow with it. These risks are certainly not insurmountable, but should be appropriately accounted for as each risk area has the potential to challenge decentralized finance growth.

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[1] https://www.nasdaq.com/articles/first-mover%3A-compounds-comp-token-more-than-doubles-in-price-amid-defi-mania-2020-06-19.

[2] https://www.forbes.com/sites/leeorshimron/2020/06/22/defi-yield-farmers-and-crypto-investors-are-raking-in-100-annualized-yields/#1e783e375eb5.

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[4]https://www.jpmorgan.com/global/news/digital-coin-payments.

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[10] See e.g. https://buckleyfirm.com/sites/default/files/Buckley-Article-Law360-Mitigating-Crypto-UDAAP-Risk-After-Ripple-ICO-Ruling.pdf.

[11] https://www.coindesk.com/bank-of-america-seeks-to-patent-crypto-wallet-that-works-like-valet-car-key.