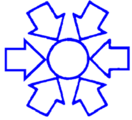 Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: April 11, 2022

When we started our own analyses of technology-based finance's stability and equality implications in 2019, we were among the first to focus on disclosures, conflicts of interest, and even self-dealing. Still, we had no idea how many sides of a trade someone could quietly be on if he or she builds out something that purports to be decentralized finance (DeFi) but is anything but. Although regulators have yet to do much about it, their first in-depth DeFi report details a raft of risks they should quickly remedy. Odds are that they won't until innocent investors and bank customers lose many of their millions, but this too-many-rules-far-too-late habit is particularly dangerous when it comes to fast-moving DeFi.

First and foremost, DeFi isn't nearly as decentralized as those touting it represent. If DeFi were truly decentralized, then it would be a lot harder for hackers to make off with everything in a DeFi platform in one swipe, but this has a nasty habit of happening over and over again. As a result, at its most essential, DeFi exposes counterparties and customers to loss of assets even if nothing else goes amiss.

And much else could. As the report from the International Organization of Securities Commissions details, DeFi is not only often centralized, but also not even all that digital. Non-digital and centralized aspects of DeFi include not just graphical interfaces with customers and fiat-currency transactions with counterparties, but also very traditional forms of finance such as leveraged trading and rehypothecation of assets that not only include fiat currency, but also nominal reserves such as sovereign bonds. Often, the only truly innovative thing about DeFi is not how decentralized the finance is, but how the finance avoids the kind of centralized internal controls and external scrutiny essential to ensuring that anything that's promised is likely to be received.

Indeed, most "DeFi" systems engage in a wide range of traditional financial activities that interface with real-world assets because that's where the money is. Many of these "DeFi" systems offer lending, borrowing, custody, payment, trading, derivatives, and asset management services. Some of these are seemingly digital – e.g., those related to NFTs – but these nonetheless allow DeFi operators many opportunities to get out in front of or behind their customers and to otherwise extract value along a transaction chain to take something – and sometimes a lot of something – on the side.

IOSCO also notes that many DeFi providers make very conventional promises that risks to fiat or even digital currency are protected by insurance or other forms of risk mitigation. On review, regulators saw little behind these promises other than still more ephemeral electronic assertions.

Are all these observations those from a disgruntled member of the "gerontocracy" grumbling about the end of a very good non-digital gig? So said Peter Thiel and so others have also asserted with considerable force.

However, basic laws of financial mechanics undergird in a newly digital world just as Newton's principles bound Einstein's relativity of quantum mechanics and quarks. Where there's money, gravitational risks born of laxity and greed not only remain, but also get larger faster when money travels at great speed with tremendous force atop untested rockets.