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Tokenization and DeFi: Regulatory Implications

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DeFi & TradFi Ecosystems

1) DeFi and TradFi converging

- DeFi & TradFi ecosystems are converging; the line between them is blurring
- DeFi is not expected to replace TradFi
- incorporating CeFi components into DeFi
- Vision of broker-dealers engaging with platforms, where persons who don't want to participate in DeFi can go through traditional regulated entities
- Stakeholders need to be able to go back and forth between DeFi & TradFi ecosystems
- DeFi Reputation: there has been a brand issue in the industry, and it's important for credibility and scale
- TradFi & DeFi – mutual recognition that ways of operating are different
- When tech changes, think of potential impacts in the system
- Consider the spectrum of players in the ecosystem and their roles

2) Defining DeFi and its attributes

- The definition of DeFi is unclear. Common lexicon is needed to have a good discussion on this industry
- A better framing or redefinition of DeFi may be "non-intermediated finance" rather than assuming all decentralized systems are free of regulatory oversight.
- Decentralization is meaningful for DeFi
 - Decentralization is location agnostic – e.g., anyone around the world can be a BTC miner – but there are jurisdictional considerations when regulation comes into play



- Some protocols presented as decentralized include centralized elements or controls
- Most use cases involve coordination through smart contracts or protocols with centralized features.
- Need a definition for what qualifies as decentralized when some actor/no actor can take control/influence
- When discussing intermediaries, we need to still define who qualifies as such
- Consider new role of intermediaries, and the right regulatory approach to take for different kinds of intermediaries. Do we need intermediaries to scale?

3) Peer-to-Peer Transactions

- There's an assumption of regulation when we engage in a transaction, but there's no regulation for peer-to-peer transactions
- This raises the question: Who do you regulate if a transaction is just peer to peer and not regulated (e.g., selling iPhone to a friend)?
- While p2p transactions don't fall under regulatory frameworks, if there's a constant flow of transactions that resembles a market, then regulation is more possible
- Some regulations still apply to p2p transactions (33 Act for issuance, potentially 34 Act for 2ndary markets)
- Sanctions apply for p2p, but p2p presents totally different issue sets
- Large size p2p transactions would still attract attention of regulators
- Controls still apply - e.g., use of credit cards for payment



Regulatory Considerations for DeFi

4) Principles & Approaches for DeFi regulation

- There is agreement that there should be regulation in the space, but it's still unclear how regulation should take form
- First principles approach is helpful
- Regulators are most concerned with unsuspecting retail investors being at risk
- Approaches to regulating commerce and internet activities can be helpful to apply for DeFi activities. (Internet had strict regulations in early days; same may be expected with blockchain). Lessons from regulation of early Internet in particular may provide helpful examples.
- There are principles from traditional finance that may carry over to DeFi, but DeFi also raises novel issues
 - Important to be specific about novel/different issues that DeFi presents (e.g., forks)
 - Consider unique circumstances that the technology presents
- Important considerations: Transaction size & defining jurisdiction and oversight
- Focus on transfer of value over transfer of information
- Activities that are not regulated can be regulated in the future. If DeFi becomes more institutionalized, there will be more enforcement and more regulations

5) Innovation vs Oversight

- Overregulating small-scale or experimental projects may restrict innovation. A proportional and flexible approach is needed.
- Regulators are still catching up to technological development. A principles-based framework may be more suitable than prescriptive rules.



- Certain helpful approaches have included sandboxes, tiered thresholds, and innovation safe zones.
- Need to preserve innovation and creativity, such that regulation does not squash innovation

6) Focus on activity, not the tech

- Regulation should focus on the type of activity, not the underlying technology. Regulation should focus on actors and the activity; the tech is backend and has had too much emphasis.
 - E.g., for stablecoins, much of existing regulation can apply for their use in light of existing activities, and this is relevant for DeFi
 - Consider - what is the “culture” of regulation we want to develop – e.g., gold is not regulated itself, but activities with it are

7) Open Regulatory Questions for DeFi

- When code is used for commercial purposes, it may fall within a specific regulatory jurisdiction. How this is determined is yet to be defined.
- Need to determine the regulatory scope, and whether a transaction is intermediated or not, no matter the asset
- Need to identify what can be controlled/supervised, and then find the gaps (chicken – egg problem)
- For manual activities, there’s a human in the loop, but open source activities are automated and this raises questions of where & how we need regulation
- Consider systemic risk and the tech stack of DeFi



- Writing software is protected under 1st amendment, but this gets blurry when regulating conduct vs. speech. What is the adequate level of accountability needed for content moderation?
- For access to DeFi, where may user interface require regulation, considering that user interface affecting transactions for securities may be analogous to a broker?
- Would blockchain be considered eligible for infrastructure-as-a-service operators subject to less KYC requirements?
- Should there be KYC for any wallet, AMM, DeFi activities, etc? What specific activities, layers, etc. should be subject to what obligations (e.g., sanctions, accountability, etc.)?

8) Regulatory Challenges for DeFi

- Existing frameworks assume the presence of intermediaries, making them difficult to apply to smart contracts or self-executing code.
- Enforcement is difficult due to the existence of location-agnostic protocols. Consider regulation vs. enforcement – whether enforcement is possible and even practical. Because regulation that is not practically enforceable is not useful.
- Market integrity & consumer protections may present conflicting agendas for regulation
- Defining the scope of commercial activities within DeFi in relation to the technology
- Focusing on regulation of securities skips many important concepts
- Regulation focuses on “plumbers” of the system, but it’s hard to determine this for a technology that is open source



- If there are no controls for DeFi protocols, then we'd have to go to the underlying platform layer on which they are built – but this would present challenges (e.g., shutting down Ethereum network)

Tokenization and Financial Infrastructure

9) Tokenization Opportunities

- Tokenization presents the opportunity to evolve from dematerialization to tokenization
- Technology allows us to do more with fractionalization
- Tokenization can improve transparency, efficiency, and liquidity in financial systems. It may allow users to bypass legacy intermediaries like DTC
- Financial system presumes only brokers can do certain activities. But tokenization gives “power to the people,” allowing anyone to do those activities, in the context of composable assets. “Power to the people” concept is threatening to regulators but very real.
- Significant focus would fall under private securities markets, particularly credit (more institutional). Tokenizing those instruments/securities can help velocity of money, liquidity, and funds going through the system more quickly
- Tokenization solves many operational challenges: better infrastructure, with ledgers that synchronize automatically
- Allowing people to take control/autonomy over their instruments/securities – e.g., to use them as collateral (vs. broker taking advantage of one's securities)
- Allowing ease of movement of portfolios (vs. today's very slow processes of moving money from one institution to another, making assets stickier)



- Opportunity to monetize – e.g., placing funds in AMM, making fees

10) Need for Taxonomy

- Lack of common taxonomy is an issue. Sets a foundation that makes it hard to build on
- Token is a misleading misnomer for a ledger entry. Token is just controllable electronic record, with ability to self-execute a transaction vs intermediary to
- Tokenizing a security is analogous to issuing a security in certain ways, but what does the token represent exactly?

11) Books & Records

- Tokens are representations of on chain ownership records. They do not change the legal classifications of the underlying asset.
- Legal clarity is needed on custodianship, transfer rights, and who has the authority to alter the official record.
- Tokenization brings difference between telling tell someone to update books & records vs just doing it oneself or via transfer agent
- One can have a paper certificate and not be the record owner
- There are rules on book entries; we have a lot of structure for that we can rely on
- Certain US states have started to accept the use blockchain for books & records (e.g., Delaware). Who has control to update books & records is key. This may be delegated to a transfer agent.



12) Role of Custody & Transfer agents

- If there's problem, we must be able to go to a custodian, who must have confidence in the records on chain
- Transfer agents – must follow the chain and choose what chains to rely on
- Does that mean owners can self-host with the risk of losing their key (choice)? Or have a 3rd party custodian?

13) Security

- Need layer of identification/KYC/tracking to confirm a person holding a token is a legitimate – investor/institution
- May need pseudo identity/derived identity approaches

14) Novel Issues

- Governance: Entry to into DeFi ecosystem involves dealing with smart contracts, which highlights the importance of governance of smart contract & the underlying blockchain itself. For instance, any challenges on the source code may lead to decisions to fork.
- Importance of considering governance at all levels of the tech stack, all the way down to the underlying blockchain
- In case of automated protocols – if a smart contract is the marketplace (e.g., acting as an exchange function) – this changes how trades are made
- AMMs allow trade & settlement to take place together



15) Open Questions on Tokenization

- Money and assets are 2 different things – what does this mean for the digital economy?
- When technology evolves, working with yesterday's problems can be very challenging (e.g., real estate doesn't require a custodian but requires transfer agent roles; is being tokenized on a certain platform and having a transfer agent role/custodian role satisfy industry and regulatory requirements?
- Security issue: Permissions on who is allowed to alter books & records - What are the different considerations that would make it ok?
- Do we need special rules for tokenizing securities?
- Do we need to think about regulating tokenized securities in a special way?
- Value & collateral being tokenized - raises questions of how we can enforce controls in this technology?
- Should regulators allow self-custody as a right?
- Should qualified investors have a choice of custody solutions, but retail investors have to work with a custodian?
- Resolving open questions on post-trade will be key – e.g., what does post-trade activity entail with tokenization? How is it different from off-chain transactions? What novel issues does it present?
- What should standards for good practices & good governance look like? – e.g., mapping for non-party/3rd party risk management
- Most tokenized offerings would fall under exempt offerings – what does this mean for regulatory requirements
- Should AML practices extend past on and off ramps? Will that be enough to control illicit funding in a more tokenized world with less need to off-ramp?
- What controls should there be in a market for tokenized activities?



- Once within a walled garden, should there be a need or no need for KYC in transactions?

16) Regulatory Challenges for Tokenization

- Need for contractual agreements to store a claim on new infrastructure
- Custody presents challenges – there may be no 3rd party custodian
- Securities are not monolithic – this presents difficulties in light of tokenization and regulatory treatment
- An activity-based regulatory approach should cover most of what occurs in tokenization. But this works only when the economic function is the same as the economic function happening off-chain. We don't yet have enough specific mapping of how the nature of economic activity with tokenization may be different than traditionally off chain activities, by means of the new technology allowing it (regardless of whether qualified investor requirement rules apply). We need a mapping of unique economic activities allowed by the technology.
- Cybersecurity risks when moving large amounts of funds

17) Stablecoins & AML

- Stablecoins have key similarities and distinctions from cash that allow them to operate in a difficult spot in the AML fight.
- Considering stablecoins as bearer instruments – innovation presents differences in how money moves
- Networks are essential for stablecoins to function as desired
- Most money laundering activity is in cash. There's a point of entry into the system, even with cash. On/off ramps are a challenge for crypto firms



- KYC/AML is important in a healthy financial system, but we shouldn't be using it as a weapon
- Stablecoin companies control smart contracts, can freeze assets, perform clawbacks, etc. – so this can be done by enforcement
- Either all participants or no participants can be allowed to transfer assets (e.g., tokenized deposits within private networks of trusted entities); but stablecoins can operate in open loops.