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Navigating through the Legal and Practical Aspects of

Decentralized Autonomous Organizations

(DAOs)

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Decentralized Autonomous Organizations (DAOs)

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Navigating through the Legal and Practical Aspects

In the recent years, blockchain technology has begun to revolutionize a growing number of fields, including the world of finance as we know it. Today, in light of a growing interest in **Web3.0** and **decentralization,** we witness the growing trend of Decentralized Autonomous Organizations ("**DAOs**") that aims to **reshape the corporate and organizational** world and bring a new power **to business and other communities.**

Furthermore, we see a growing number of businesses exploring ways to **monetize the opportunities** created as part of this trend, by offering **various services for DAOs**, or services provided **on top of DAOs' protocols.**

DAOs raise novel complex legal and regulatory issues and risks, which should be properly evaluated and addressed by anyone seeking to establish, invest (or contribute) in, become a member of or provide a service to or with relation to a DAO.
In this piece we will present some of the key such issues and risks.

What is a DAO?

A DAO is a self-governing, **blockchain based community-led organization** that is organized around a common mission or goal. The DAOs' autonomous feature is manifested in **governance rules** programmed into blockchain-based **smart contracts** so that **DAO members can vote on matters affecting the DAO** solely in accordance with these rules.

In a DAO, generally, the underpinned smart contracts may be considered to be **analogous to a company's memorandum of incorporation.** However, these smart contracts do not only define the organization's rules but are also able to hold the organization's **treasury**, and as such to enable the automatic authorization of payments, e.g. in accordance with community votes. Once the smart contract is deployed on a first-layer blockchain (like Ethereum, Solana or BNB Chain), the rules can be amended solely through a pre-defined mechanisms of a protocol such as community voting. Specific **governance tokens** are typically used as part of voting mechanism. Nevertheless, due to the feasibility limitations, many day-to-day operations cannot be automated and are still made **off-chain**, which in many cases may raise concerns regarding a true decentralization of a DAO.

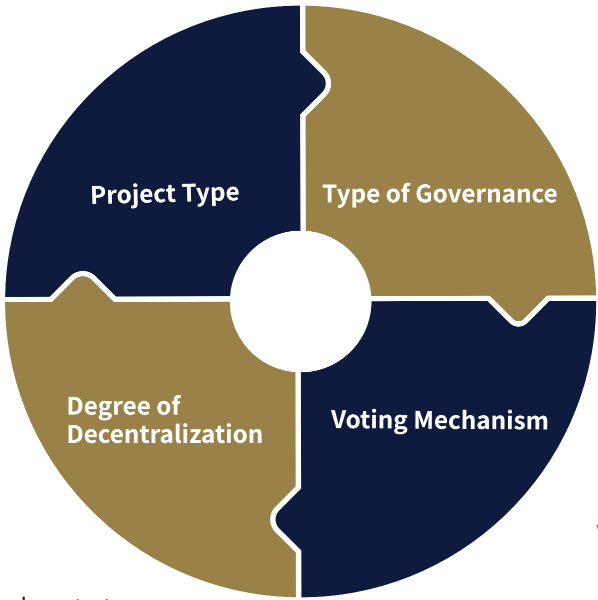
A wide array of DAOs is currently in place, and they **typically differ** by the following elements and examples:

Project Type

- Protocol DAO
- Investment DAO
- Media DAO
- Grants DAO
- Collector DAO
- Social DAO
- Operating system

Type of Governance

- On-chain
- Off-chain
- Hybrid governance models



Degree of Decentralization

- The ability of a specific third party to affect its operation or development
- Conducting the entire operation as a DAO v. decentralizing only specific parts of the operation / decision-making

Voting Mechanism

- Delegation of a voting power vs. direct participation in votes;
- ways of calculating the voting power (based on the amount of governance tokens / the time of possessing or locking / quadratic / other complex voting mechanisms)

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Why DAO?

The creation of DAOs is not only a matter of ideologically driven tech and crypto enthusiasts, but also of various market players who understand the **unique advantages of a decentralization** for their business in general, and DAOs in particular.

Compared to traditional companies, DAOs are **more transparent** and **non-hierarchal,** which, inter alia, can reduce the consecration of power, corruption, and censorship. In addition, operating as a DAO reduces **transactions cost,** turning organizations to be more efficient and allows the organization and its operation to be **truly global.**

DAO	Traditional Organization
Transparent	Mostly not Transparent
Distributed Network of Autonomous Stakeholder	Top- Down Management
Fully Global	Geographically Limited
Complex Execution and Enforcement	Autonomous Enforcement

While DAOs are still in their infancy, in the recent year we have seen mergers of different DAOs, and we may expect to keep seeing further developments of DAOs' types and use cases, as well as best practices for DAOs' structure, governance and decentralization models.

DAOs Legal and Regulatory Considerations

While the DAOs advantages are clear, its unique characteristics and structure **create notable legal and regulatory risks**, many of which are entitled to a wide degree of uncertainty. In the absence of clear regulatory framework, the **navigation of the DAOs domain is incredibly complex** and requires a great degree of deep understanding and caution, as each decision associated with DAO design, such as decisions on the **structure, governance model** and **voting mechanism**, the **degree of decentralization** and on the **type of a DAO** are likely to affect the DAO's ability to meet **various legal and regulatory requirements.**

Different stakeholders in the DAO domain - mainly **developers** of (e.g., core team), **investors** in (including contributors), and **members** of DAOs - but also **service providers** and **advisors** thereof should be aware of and seek to properly, among others, the following key legal and regulatory risks and considerations:

1. Lack of legal entity

The DAOs' structure is yet to be recognized as a separate legal entity in the vast majority of jurisdictions, and thus currently is generally considered at a **significant risk to be a 'general partnership' or its equivalent.** Consequently, two key types of risks should be taken into account:

Lack of Separate Legal Personhood

- The DAO has no separate legal personhood, and thus, among others, it is limited in its ability **to enter into contracts**, own a **property** (including protecting intellectual property), hold off-chain **assets**, open **bank accounts** and operating with financial services providers, conduct **cash** or other fiat transactions, file or pay **taxes** and obtain **regulatory authorizations;**
- The lack of separate legal personhood invites arguments that the developers of the DAO, even if not DAO members, remain **personally liable** for its operation.

Lack of Limited Liability

- The DAO members as a default have **no limited liability**, namely DAO members (including investors) may be fully liable for the DAO's actions and omissions;
- This is especially important for **significant investors** in DAO governance tokens and for the **core team** which typically possesses a significant portion of tokens.

In light of the aforementioned complexity, several jurisdictions have introduced **unique legal instruments for incorporating DAOs** in various tailored limited liability company forms, e.g. in the United States - Wyoming LLC and Vermont blockchain-based LLC, as well as the Marshall Islands LLC. Other jurisdictions have offered **alternatives for 'wrapping' a DAO** or part thereof that are based on other existing legal structures, such as foundation companies.

> The currently existing legal 'wrappers' for DAOs are diverse, and the decision of whether a DAO should be incorporated or otherwise 'wrapped', and if so, how and in which jurisdiction, shall be made on a case-to-case basis, and tailored to each DAO's specific goals, needs, governance structure and regulatory exposure.

2. Securities and Financial Regulations

Two key types of risks should be taken into account with respect to these types of regulations, violation of which, among others, may result in a **criminal** or **administrative liability** of a DAO, its core team or its strategic investors:

Token Issuance

- DAOs are typically governed using, so-called ‘governance tokens’, namely tokens which grant voting rights to their holders, whether directly or indirectly;
- Such tokens may also have additional functionality, and may, to some degree, resemble company shares. As such, governance tokens (as well as other tokens issued by a DAO or on its behalf) are typically at risk to be considered security or financial instrument in different jurisdictions, the issuance of which is subject to extensive obligations under securities laws (such as registration and prospectus requirements);
- In order to address such risks, the **DAO's tokenomics and protocol structure, including its governance structure, as well as its operation strategy, should be closely evaluated from a regulatory perspective and designed accordingly.**

Regulated Operations

- Significant amount of DAOs are operating today in the decentralized finance (**"DeFi"**) domain and as such de-facto offering various services and products which are financial in nature with respect to crypto-assets, such as, among others, a provision of a trading venue, lending platform and other deposit account equivalents.;
- Such activities may fall under securities, banking and other financial services laws and be subject to various regulatory requirements in a myriad of jurisdictions;
- Despite common misconception, **DAOs are not automoatically exempt from being subject to such regulatory regimes, and therefore it is of great importance to design the product and the underlying protocol in a compliant way,** especially due to the potential relative complexity in making changes thereto which typically requires community's approval.

3. Anti-money Laundering and Counter-terrorism Financing ("AML/CTF")

DAOs that operate in a DeFi domain (or in one of several additional industries), as well as their core teams and strategic investors, are at risk of violating **AML/CTF legislation** and be subject to **criminal** and **administrative sanctions.** Such risk arises especially due to DAOs' typically **permissionless and anonymized nature,** which is generally not in line with know-your-customer (KYC), customer due diligence (CDD) and reporting requirements under the applicable AML/CTF regulations.

While the Financial Action Task Force **(FATF)** and other regulatory bodies make efforts to bring regulatory clarity in this respect, and in parallel technological as well as operational solutions for decentralized permissioned platforms are being rapidly developed, the regulator's focus on the matter has significantly increased.

Such increased regulatory risk compels DAOs in a DeFi domain to adopt novel restrictive measures, and properly evaluate and address the applicable AML/CTF regulatory framework in order to ensure compliance.

4. Tax

DAOs' operations also raise complex legal questions related to taxation, including without limitation with regard to the **jurisdiction** and **regime** to which the DAO is subject, including with regard to tax payment and reporting of the income arising from its operations, given that the members of a DAO may maintain a certain degree of anonymity. Such and other issues arise from the DAO's token issuance and sale activity as well.

5. Additional Considerations

The above constitutes only a **short list of the legal risks and complexities** DAO projects and their stakeholders may face.

DAOs operating in a niche fields, such as insurance or health sector may also be subject to **additional regulatory requirements arising from a sector-specific regulation**, which may not be easy to fulfill in light of DAO's unique characteristics.

Furthermore, the applicability of **privacy and data protection, consumer protection** and **eCommerce regulation**, as well as **corporate** and **bankruptcy** laws and regulations to DAOs raises various complex legal issues.

The risks and complexities are further enhanced by the **dynamic nature of the regulatory regimes applicable to DAOs** which are currently taking shape around the world. For example, it is yet to be seen how DAOs will be affected by the final version of the **European Markets in Crypto-Assets (MiCA) Regulation** which is expected to be adopted in the near future, as well as how DAOs will be affected by the US regulatory regime following recent US President's Executive Order on Ensuring Responsible Development of Digital Assets which has emphasized the risks associated with decentralized financial ecosystems.

In order to navigate this complex, uncertain and rapidly evolving domain, a deep understanding of DAOs, their models of operation and applicable regulatory framework, as well as a global and multi-practices perspective is a necessity.
HERZOG's Fintech, Crypto & Blockchain experts have gained a unique specialization in DAOs' legal, regulatory, business and other practical aspects and is a pioneer legal team in advising our clients, as well as closely escorting them in execution, of their unique DAO projects.

HERZOG Technology & Regulation Department

Herzog's **Technology & eCommerce Regulation Department** is a recognized market leader in its field. The team is led by domain experts who possess a unique set of vital, **interdisciplinary** and **global** regulatory advisory skills, and are uniquely positioned to advise a range of clients, including leading multinational

compliance considerations in numerous technological areas.

We understand that the **regulatory exposure** and scope of required **attention** of almost any company operating in the **digital and technological sphere** are much wider than one specific jurisdiction or legal discipline. As our clients are often on the forefront of this ever-evolving landscape, we further understand the impact of industry trends and compliance demands on our clients' businesses. Therefore, our team possesses in-depth knowledge of the increasing volume of regulations, enforcement actions, legislative and industry trends in a **myriad of jurisdictions, digital platforms** and leading **self-regulatory** guidelines. This enables our team to offer **practical, holistic** and **comprehensive** solutions for complex situations often presented by innovative technologies and disruptive business solutions, providing "hands-on" support to our clients on the strategic, corporate and operational aspects of their business, with the aim of mitigating our clients' legal and business risks.

Technological developments in recent years are reshaping the world of finance, payments, trading and investments. Our department's **Fintech, Crypto & Blockchain** team has positioned itself at the forefront of this burgeoning industry by providing a holistic suite of end-to-end legal services, to assist clients in operating their businesses in accordance with all the applicable regulatory and business considerations. Our clients include international operators and creators in the crypto sector, financial technologies and payments providers, banks and finance intermediators.

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