



## Response to the Law Commission of England and Wales Decentralised Autonomous Organisations (DAOs) Call for Evidence

### Holland & Knight DAO Working Group\*

This call for evidence is both timely and necessary; we appreciate the opportunity to provide our views regarding the legal implications of DAOs. DAOs are already employed as a component of numerous virtual asset services. However, the 2022 implosion of many centralized virtual asset service providers and hedge funds—the consequences of which continue to ripple throughout the interconnected digital asset ecosystem—has accelerated investor and consumer interest in decentralized services. In the United States, this increasing DAO-related economic activity has resulted in regulatory scrutiny, including enforcement actions, and a number of private party disputes. These actions have highlighted the legal uncertainties surrounding DAOs. We provide this contribution to assist the Commission in reforming the law in the United Kingdom to address these uncertainties.

### Responses

#### Question 3.

**We recognise that there is no singular, authoritative understanding of what a DAO is. However, please explain how you understand each of the individual descriptors of a DAO:**

- 1) decentralised;
- 2) autonomous; and
- 3) organisation.

While the individual terms have a substantive meaning in and of themselves, in practice the term “DAO” is used to apply to a broad range of entities, with a wide range of characteristics, which makes coming up with an all-encompassing definition of the term and its constituent terms difficult. Given this, it is important to set substantive standards for the meaning of the term “DAO” as well as its constituent terms, which go beyond how the terms are commonly used, in order to develop a meaningful policy and regulatory framework for DAOs.

To illustrate, the term “decentralised” broadly refers to the fact that a DAO distributes (or “decentralises”) the power to make key determinations amongst a group of (theoretically) independent parties, as opposed to being “centralised” in a single entity. However, many DAOs are constructed in a manner making it possible for a single entity to buy up an inordinate share of voting power, thus transforming a purportedly decentralised entity into a de facto centralised entity. In the case of voting power arising solely from DAO governance tokens, on-chain examination of the distribution of DAO governance tokens is insufficient to determine to what extent a DAO is decentralised in any meaningful way. For example, a single entity could hold in many different addresses an outsized share of DAO

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voting power; or a single entity could form off-chain proxy or voting pooling agreements with other DAO token holders.

The term “autonomous” broadly refers to the fact that a DAO’s operations are *solely* determined by the rules embedded in the self-executing smart contracts on which a DAO is operating; thus, a DAO (again, in theory) requires no managers or bureaucracy to operate. However, several DAOs are organised in a manner requiring intermediaries at different stages of the DAO decision cycle. DAOs thus fall somewhere on a spectrum of autonomy; it is not always clear to stakeholders or customers to what extent a particular DAO is as autonomous as the term implies.

These examples show how a DAO’s constituent terms may be unhelpful or outright misleading, demonstrating the need for developing standards to lessen the ambiguity, uncertainty, and customer confusion surrounding these terms.

## Question 5.

**Do you agree that the general starting point for DAOs might be that they are characterised as an unincorporated association, or a general partnership under the law of England and Wales?**

**In this question we are interested in the legal treatment of a DAO which has not taken any of the additional steps that we discuss in this call for evidence, for example either structuring itself with a variety of incorporated or unincorporated entities or using decentralising elements.**

**Please explain whether your answer is based on general knowledge of DAOs or based on specific examples of DAOs of which you have first-hand knowledge or experience.**

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Our firm has researched every regulatory and court action in the United States involving DAOs, both as part of ongoing engagements and to understand how legal practitioners approach DAOs in different contexts. Our working group also has first-hand knowledge of several specific DAOs.

In responding to this question, it is important to distinguish between some common uses of the term DAO. Some will use the term DAO (1) to refer only to the holders of a DAO’s governance tokens; (2) to refer to the collection of developers, managers, promoters, and token holders who all participate in the DAO’s decision cycle and operations; or (3) to refer to the virtual asset service the DAO provides. The first and second uses of the term DAO refer, fundamentally, to people working collectively for some purpose. It is our view there is no precedent to treat DAOs in this sense any differently than any other group of people working collectively. Determining how to treat them under the law should proceed according to the law of the appropriate jurisdiction, examining the specific context of each DAO. This treatment creates uncertainty for the DAO participants, as it would in any other context where people collaborate absent formal legal entities, but highlights the need for DAO stakeholders to consider how best to mitigate against uncertainty using existing legal structures.

The third use of the term, referring to a virtual asset service as a DAO, confuses a service or product with the entities offering that service or product. This confusion is present among practitioners unfamiliar with DAOs. In this misuse of the term DAO, the subject is merely the protocol offering the service or product—computer code—and thus it is inappropriate to characterise the “DAO” as any form of association or partnership.



## Question 9.

### **What are the biggest benefits of using incorporation as part of its organisational structuring that might lead a DAO to consider this option?**

In our response to this and other questions relating to incorporation, we consider corporations and other legal forms (e.g., limited liability companies) in the same vein. The biggest benefits to organising using legal forms are, generally, certainty and risk management. Legal structures:

- dictate the fiduciary duties owed by promoters, stakeholders, officers, and directors, preventing abuse of access, authority, or power;
- determine how and who can bind the organisation to agreements with third parties, creating certainty in commercial transactions when dealing with the organisation and thus reducing barriers to the organisation when contracting with third parties;
- establish protections for minority stakeholders and prevent abuse of power in closely held organisations;
- establish mechanisms for receiving correspondence and legal process, ensuring the organisation has notice of legal proceedings and further legitimizing the organisation in the eyes of third parties by having a known point of contact; and
- create processes for formation, reporting, and dissolution which address the uncertainties of asset ownership and liability during the life cycle of an organisation.

The appropriate legal structure for any DAO is context-specific and will vary based on the jurisdiction.

## Question 10.

### **Why would a DAO choose not to use incorporation as part of its organisational structuring (in England and Wales, or elsewhere)?**

In our experience, DAOs choosing to forego incorporation are generally of two types: either because (1) DAO participants view the act of incorporation as compromising on key constitutional principles such as decentralisation and autonomy; and because (2) they view the practical burdens of incorporation cost and legal certainty as too high.

With regard to the constitutional principles, it is our view that, while “decentralisation” may have been a foundational motivating factor in the inception of DAOs—creating a digital commune of diverse stakeholders—the decentralised ideal is no longer an indispensable characteristic in practice. As mentioned previously, many DAOs are or have the potential to be more centralised than their name would suggest. And, as DAOs evolve, we are increasingly seeing their operations more closely resemble traditional corporate structures. Centralising some aspects of operations are in tension with the decentralised ideal, but the ideal appears to be losing ground to the practical efficiencies offered by centralisation.

Similarly, DAO stakeholders may eschew incorporation because the concept runs contrary to the principle of autonomy. In theory, a DAO’s operations should be entirely on-chain and self-executing



based on DAO's coded rules. Moreover, one school of thought by DAO proponents seeking autonomy holds that the self-executing nature of the DAO renders it unaccountable to regulatory oversight. This view is grounded in either an ideal (a DAO is technology outside the purview of any regulator); or the practical (DAOs are not entities and thus cannot be served with legal process or held liable). These views are unsustainable, however; sovereign entities will find ways to bring the operations of DAOs under regulatory umbrellas and within reach of courts.<sup>1</sup>

Some DAOs may merely be seeking to avoid the costs and burdens of structuring operations within a legal form. But DAOs do this at the risk of uncertainty to all DAO stakeholders regarding their personal liability for DAO activities. Indeed, certain DAOs may be deliberately seeking shelter in the uncertainty their lack of legal formality creates, in an attempt to avoid or delay regulatory accountability and liability for DAO operations.

In our view, the uncertainty of operating DAOs outside of a legal structure is risky and outweighed by the benefits of organising DAOs within appropriate legal forms.

**Where a DAO does choose to use incorporation as part of its organisational structuring, are there any requirements or ongoing obligations, such as reporting, that are challenging for the incorporated entity to comply with as part of a DAO?**

No. To the extent there are compliance questions, we or other sufficiently knowledgeable counsellors are able to guide DAOs through perceived challenges.

#### Question 11.

**Please explain whether any or all of the available existing legal forms are unsuitable or unattractive for those DAOs that wish to use them as part of their organisational structuring.**

In our view, the appropriate legal form for any DAO is context specific. Some legal forms will be more attractive than others, depending on the DAO's activities and governance structure.

#### Question 12.

**Are there jurisdictions other than England and Wales that provide a legislative approach to legal forms that is more effective or attractive for use by DAOs?**

**What are the advantages and disadvantages of those other jurisdictions, legal regimes or legal forms for DAOs in arranging their organisational structuring?**

In the United States, several States have provided a legal framework for DAOs: Vermont, Wyoming, and Tennessee. These laws aim to create regulatory clarity and legal recognition and attempt to facilitate DAOs in their operations while providing consumers with appropriate disclosures regarding DAO operations.

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<sup>1</sup> See, e.g., *CFTC v. Ooki DAO*, No. 22-cv-05416 (Cal. N.D. Jan. 17, 2023) (defaulting a DAO for not responding to legal action by the United States Commodities and Futures Trade Commission for the DAO's alleged violation of commodities trading laws).





Evaluating the advantages and disadvantages of these legal forms and comparing them to other options is difficult to do in a vacuum. What is right for one DAO may be not be right for another; evaluating a DAO's needs is better done on a case-by-case basis with experts who understand the DAO's objectives and governance structure.

## Question 15.

**To assist in our understanding of the use of crypto-tokens by DAOs, please provide further information on whether software protocol-specified tokens are designed to confer similar rights on holders to the holding of share capital in a business, or equivalent to the holding of a partnership interest in a business.**

There is no generic analog for a DAO governance token, because there is not a universal standard for what rights those tokens confer to their holders. DAO governance tokens could represent voting rights; ownership rights to certain assets; rights to profits; other rights; or any combination of rights—or even no rights! Analogizing to corporate shares or partnership interests or other forms of equity can only be done by examining a particular DAO.

## Question 16.

**Please describe how you characterise the relationship between (i) DAOs; (ii) developers and / or incorporated companies (or other legal forms or incorporated entities) involved in software development; (iii) software protocols based on open-source code.**

Generally, we would characterise the DAO as the group either operating part of or owning equity in the DAO's business.

Responding to the second and third parts of this question requires understanding which software and open-source protocols are being examined. A DAO may have any number of software components, including governance smart contracts, dictating the rules of how the DAO conducts its activities and makes amendments to its business; smart contracts which provide services to customers; and web site or app front-ends to the DAO's services.

Depending on the context, DAO software developers may be employees or contractors; and there is often relationship overlap in DAOs, where DAO developers also own equity or governance tokens, particularly where the DAO software developers are also founders or act as officers or agents for the DAO.

Software protocols based on open-source code are products made by coders. Typically, when one discusses a DAO's protocol, one is discussing the DAO's service being provided by a self-executing smart contract. A DAO's governance smart contract(s) may function, at least in part, as the rules by which the DAO operates; in this context it is the analog to the articles of incorporation and operating procedures for a conventional business. In either event, those smart contracts are products made by software developers.

## **What are the legal uncertainties and / or risks that you consider are inherent in this characterisation?**

Without responsibilities defined by either contracts or a legal form in which persons have known roles and expectations, DAO stakeholders are exposed to enormous uncertainties: who owes what duties to



whom? Who is liable in the event something goes wrong—such as the code operating in an unintended fashion, or a majority stakeholder embezzling from the DAO’s treasury?

**How important is legal certainty with respect to the scope of duties of care and / or fiduciary duties of developers of open-source code for software protocols / blockchain protocols for DAOs and their participants?**

Incredibly important. DAO founders, promoters, stakeholders, and software developers may be exposing themselves to immense and uncertain liability because they are leaving it to the courts to determine to what extent they may have duties to others in the DAO context—or whether any warranties apply to the DAO’s services—absent contracts between the parties or operating the DAO within a legal form.

It is likewise important for DAO customers—leaving courts to determine whether a DAO or DOA stakeholder is liable to customers for customer harm is risky.

**Question 22.**

**Please explain any other practical and legal structuring tools that DAOs use in both their blockchain based and non-blockchain based activities. If possible, please explain how you see these techniques interacting with principles of private law.**

DAOs that are involved in the metaverse may be a constituent part of procedures for resolving intellectual property (“IP”) disputes, given a metaverse’s Terms of Service. These procedures are likely put in place in order to limit liability under the safe harbor provision of the DMCA (“Digital Millennium Copyright Act”). For instance, one such DAO’s Terms of Service contains language prohibiting the violation of IP rights, which it does via a DAO-approved Content Policy. Claims of IP infringement are handled by the Foundation, a nonprofit entity, purportedly independent of the founders of the DAO, to which notices of infringement can be sent. In the case that the purported infringer challenges the notice of infringement, the DAO determines whether the subject content must be removed, which is made via a vote of metaverse participants (likely by a simple majority).

Given the way in which intellectual property disputes are dealt with, there is a possibility that metaverse DAOs (or some related entity) may be subject to liability, where the DAO’s IP dispute determinations effectively prevent the DAO from enforcing IP rights in good faith. This might happen where parties with an interest in the outcome of a DAO IP determination anonymously utilize voting power to procure outcomes favorable to themselves. Where the DAO is unable to consistently enforce IP rights upon receipt of notices of infringement, the safe harbor provision of the DMCA may no longer apply, though it is unclear exactly who may be considered liable in this instance.

**Question 23.**

**How do DAOs (or the constituent parts thereof) structure their governance and decision-making processes? Please provide examples, including (if possible) where such processes have worked and have not worked.**

With respect to a metaverse DAO in which we have first-hand experience, decision making power is distributed via the concept of voting power, where an individual gets an amount of voting power based on the amount of the DAO’s native cryptocurrency held by the individual and names and virtual land



they own. The stated reason for this form of distribution is that it allows individuals to have a share of voting power in direct proportion to the extent to which they invest in the DAO's metaverse.

Decision-making processes are generally divided into two different categories, **Proposals with Direct Binding Actions**, and **Governance Proposals**. Proposals with Direct Binding Actions are subject to a round of voting, where a proposal must secure a minimum threshold of voting power, and also a simple majority of voting power, in order to pass. Proposals with Direct Binding Actions are limited to a set group of categories in terms of content: (1) funding a community project through the transfer of the DAO's resources; (2) adding a catalyst node to the network of servers that host and run the DAO's metaverse; (3) adding or removing points of interest or highlighted locations to a list that helps users find places to explore; and (4) banning names from the metaverse.

Governance proposals refer to more complicated proposals where the implementation of a proposal is not simply a matter of triggering pre-existing smart contract code. Governance Proposals involve a three-stage voting process including a Pre-Proposal Poll, a Draft Proposal, and a Governance Proposal, where each step has heightened minimum threshold requirements. Because such proposals are not simply a matter of triggering existing smart contract code, DAO determinations involve proposing an "implementation pathway" that requires formalizing proposed code to be merged with the smart contract code that makes up the DAO's metaverse. There is thus a possibility that the implementation of Governance Proposals may not be "immediate" in the sense that a DAO's determination may not directly lead to the implementation of a proposal.

## Question 27.

**We welcome suggestions from stakeholders as to other issues which should be included in our scoping study. For each issue, we would be grateful for the following information:**

- 1) a summary of the issue / problem;
- 2) an explanation of why the issue needs to be considered. For example, problems that it causes / could potentially cause to DAOs in practice; and
- 3) suggestions as to what could be done to address the issue, and any evidence of the costs and benefits of the solution.

There are general issues regarding distribution of power and the immediacy of implementation that can create problems for a DAO. For example, in a metaverse DAO, because an individual's voting power corresponds to the individual's ownership, and because individuals can own land, names and DAO tokens anonymously, it is possible for an anonymous individual to have an overwhelming share of voting power when it comes to voting for a proposal. This individual could then secure governing policies that are inordinately favorable to itself. Especially where a metaverse's community is not particularly active as it relates to voting, this could be a significant problem.

This particular metaverse DAO appears to be trying to address such issues through the creation of a delegate program, where individual owners who may not themselves be actively involved in governance can delegate their voting power to a list of delegates who are chosen through an application process, and who demonstrate an interest in attending to the governance of the DAO's metaverse (though technically an individual can delegate their voting power to anyone).

Because these delegates are active in reviewing proposals that are offered up for DAO determination, this helps ensure a higher amount of de facto participation in the DAO's governance. As the delegates



are also chosen through an application process, this helps in theory to moderate the effects of bad actors, who might try and secure biased proposals through the purchase of a large amount of voting power. Whether such a system is sufficient to deterring the effects of bad actors on the DAO is unclear, though the DAO tracks metrics regarding the amount of voting power that has been assigned to its designated delegates.

This problem is representative of one facing many DAOs: that is, how to ensure a DAO is not abused by an individual that has a pooled sufficient voting power to enact proposals that would disproportionately benefit the individual to the detriment of other DAO stakeholders or DAO customers.