



CUMMINGS PEPPERDINE DEMYSTIFIES DAOS

PART I

WHAT IS A DAO?

Decentralised autonomous organisations (“DAOs”) do not have one universally accepted definition but they are largely considered to be a mechanism which allows groups of people to make decisions about the running of a project. They are also very flexible – they can be set for any purpose or objective.

One useful definition is that given by Jack du Rose, co-founder of Colony. He has defined DAOs as

“... a type of decentralised application which incentivises its users to engage in activity which furthers its agreed business objectives by enabling them to work together without requiring them to trust one another.”

We can work with this definition and build on it as we run through demystifying DAOs.

The acronym DAO comes from the fact it uses blockchain, hence “decentralised”, as it has no central leadership and decisions get made from the bottom-up and as its governed by a community organised around a specific set of rules enforced in the blockchain, hence “autonomous” and it is an internet-native entity, hence “organisation”.

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HOW DOES A DAO WORK?

The mechanism which DAOs use, to allow decisions to be made about the running of a project in pursuit of a common goal, is built using blockchain and smart contracts.

Just as a refresher, blockchain is a decentralised database or ledger that is distributed between nodes in a peer-to-peer network and smart contracts are computerised transaction protocols which execute contractual terms where the rules of governance are transparent.

The smart contract terms are distributed to all nodes in the peer-to-peer network in a manner which prevents any single party from directly forcing the DAO to act in a particular way. Thus, the DAO must abide by its specific programmatic set of rules which should be tamper-proof.

An additional layer of security is often built into DAOs ensuring that if anyone tries to carry out an action which is not covered by the rules and logic in the code, it will fail.

Additional, because the treasury function is also proscribed within the smart contract, no one can spend any of the DAO's money or other assets without the required member's approval.

DECENTRALISED? AUTONOMOUS? ORGANISATION?

The words used to describe a DAO can each be looked at in light of the above, to work towards an understanding of what they are and what they do.

Decentralised: the characteristics described above show why a DAO is decentralised – it does not need any central authority to run it or enforce any agreed terms.

Autonomous: yes, they really are. And DAOs can also be transparent. As they are built on open-source blockchains, anyone can view

their code, audit their built-in treasuries as the blockchain records all financial transactions, and carry out other activities which are allowed.

Organisation: perhaps this is slightly misleading as a DAO is not an organisation in the sense of a company or partnership, but it is a group of people who come together to conduct activities in accordance with a set of pre-defined rules. It could be seen as an organisation in the sense of a club – see issues below.

HOW DO YOU SET UP A DAO?

There are three material steps in the setting up of a DAO: creation, funding and deployment.

Creation of the smart contract: Each DAO needs to determine how it will enact governance, and then engage developers to create a tailored smart contract.

Once launched, the rules of a smart contract can only be changed in accordance with the rules for change which are set out in that smart contract, using the prescribed governance system.

The smart contracts should always be subjected to extreme scrutiny and tested before deployment to ensure they have been corrected established and without any glitches. It is good practise for this review and testing to be undertaken by an independent developer.

Funding: Each DAO also needs to determine the manner in which it will receive funding.

Generally, tokens are sold to raise funds and it is the tokens which give holders voting rights. This is where a legal and regulatory analysis becomes key. Lawyers should be instructed to determine whether the tokens will be subject to regulation as "security tokens" or other forms of regulated digital assets. This will often mean the lawyers work hand-in-hand with the developers as well as the founders of the DAO.

Deployment: The DAO will be deployed on the blockchain and from this point on, its members (often token holders, as described above) will decide on its future in line with the purpose or objectives set out in the smart contracts.

ISSUES WITH DAOS AND STRUCTURING

DAOs are still new technology and there remain lingering concerns regarding the legality, security and structure of DAOs. These are critical issues which should be addressed at the start of creating any DAO.

A key legal action comes from the US in late March 2023. In this case, a federal judge in California found that simply owning a token in a certain DAO, the bZx DAO, could create legal liability for holders. The Judge found that the specific structure of the bZy DAO constituted a valid general partnership, meaning that its token holders could personally liable for lawsuits.

It seems that a key issue here is that the Californian judge held that that bZy DAO appeared to the Court to be a partnership in DAO's clothing and as other jurisdictions including the United Kingdom use partnerships (which should be distinguished from a limited liability partnership), this overseas view may be relevant in the United Kingdom.

There are solutions. One which is commonly used is to include a wrapper in the overall structuring of a DAO. This wrapper can take the form of a foundation (a newish form of legal entity) either in the Cayman Islands or Switzerland.

A Cayman foundation company is a body corporate the legal personality of which is distinct from its members (although members are not a requirements and this point can be a key consideration when deciding on the best wrapper for any DAO), directors and other connected persons. Unless varied by constitution, the duties owed by this type of wrapper are only those owed to the Cayman foundation company itself. Additionally, rights are enforceable only against the Cayman foundation company.

HOW CAN WE HELP?

DAOs are continuing to evolve, and their use cases are clearly visible. But as you can see, they need careful structuring right from the start. At Cummings Pepperdine we can advise and assist you with:

- structuring your DAO;
- negotiating the terms of the smart contracts;
- finding the best wrappers;
- complying with anti-money laundering regulations and other laws; and
- the regulatory implications of the issuance of tokens.

THE TEAM

Cummings Pepperdine is a leading advisor in crypto. We are one of a select few that advises a large and diverse global client base in the crypto space and the only to provide a complete crypto solution building on the three key areas of law, tax and FCA with legal underpinning at every point.

In law, we have a team of qualified and regulated solicitors and a barrister who retains right of audience.

In tax, we have one of the only crypto tax advisors who is both a qualified solicitor and qualified chartered accountant.

In regulation, our team comprises specialists in crypto compliance monitoring structures and governance oversight who are known to the FCA for the quality of their work.

The team is led by Claire Cummings, a leading solicitor specialising in crypto law and the current and evolving regulation. Claire is on the advisory boards of a crypto exchange and an NFT gaming guild and is also a member of the Global Digital Finance working group on



Claire Cummings

stablecoins. Claire has also acted as compliance officer, MLRO and director of an FCA regulated fund manager and qualified under SIB to trade derivatives. As a leading expert in crypto, Claire is a sought after speaker and has published multiple articles on the legal and regulatory issues surrounding cryptocurrencies and the crypto eco-system. Claire is named at the Top 10 influencer in London for hedge funds (2&20, 2022) and is included in the CityWealth Crypto Top 100

The Cummings Pepperdine Online Training Programme, includes sections focussing on Demystifying DAOs , has been designed by a specialist board of compliance consultants, solicitors, chartered accountants, tax advisors and regulatory consultants. We believe that we are the only firm which offers training created by this range of qualified advisors.

[Click here now to make it all work](#)

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