Defending the Crypto Space | Decentralized Law #2 | December 2021

BanklessDAO Monthly Legal Newsletter

Dear Crypto-Legal Observers,

In most areas of practice, lawyers are laser-focused on protecting their clients' interests within the narrow scope of their engagement. In contrast, lawyers working with blockchain projects must view their efforts through a much broader prism. The current absence of legal certainty demands that lawyers continually stay informed about ongoing regulatory developments, particularly in relation to emerging legislation and third-party actions. On top of all this, most crypto-lawyers seem to be involved in a common effort: defending the crypto space!

Defense of the crypto space is a necessary pursuit, with the future of the industry in jeopardy due to a widespread lack of understanding by lawmakers. The very real risk is that heavy-handed regulation will hamper further development and deployment of blockchain-based innovations, curtailing the industry's potential for political, economic, and social disruption.

How can lawyers best protect the crypto space?

Lawyers should think of themselves as both students and educators. Working with cutting-edge clients in the crypto space gives lawyers a privileged position from which to develop a comprehensive understanding of the blockchain industry's potential to address a wide array of societal concerns, from unbanked populations to open elections to cleaner air. With this deep understanding, lawyers should then work to educate legislators to help stave off potentially harsh regulations while advocating for legal certainty.

Alongside crypto-lawyers, a first wave of crypto-native executives are working hard to persuade legislators to draft thoughtful laws that will lead to clear regulatory frameworks. This persuasive effort was on display at a recent U.S. House Committee on Financial Services hearing, where crypto CEOs had the opportunity to offer testimony concerning their industry and the need for more certainty from Congress.

https://twitter.com/SBF_FTX/status/1468690360465608704?s=20

https://twitter.com/YahooFinance/status/1468605332872044544?s=20

Crypto CEOs work shoulder-to-shoulder with legal advisors—particularly at major protocols with significant political and legal exposure. These projects need an experienced and influential General Counsel capable of dealing with the myriad political and legal matters inherent to the borderless nature of the cryptoverse. This issue of *Decentralized Law* features an interview with Marc Goldich, the General Counsel for Terraform Labs. Marc shares insights gained while working with those in the upper echelons of the crypto space.

The remainder of this issue includes Part I of an examination of the prospective European MiCA regulations, analyzes blockchain-based alternative dispute resolution mechanisms, compares traditional corporate governance to DAO governance, considers the conditions under which NFTs could be considered a security, and uses the fascinating case of ConstitutionDAO to discuss taxable events.

Although this newsletter may help to familiarize readers with the legal implications arising from blockchain technology, the contents of *Decentralized Law* are not legal advice. This newsletter is intended only as general information. Writers' opinions are their own; therefore, nothing in this newsletter constitutes or should be considered legal advice. For that, contact a legal expert in your jurisdiction.

A note to readers: beginning in January 2022, we will ship a shorter edition of *Decentralized Law* twice monthly. We appreciate your readership. And we thank you for defending the crypto space.

BanklessDAO Legal Guild (eaglelex, lion, hirokennelly.eth, taxpanda, Terumask, drllau, Trewkat, Cheetah, MDLawyer)
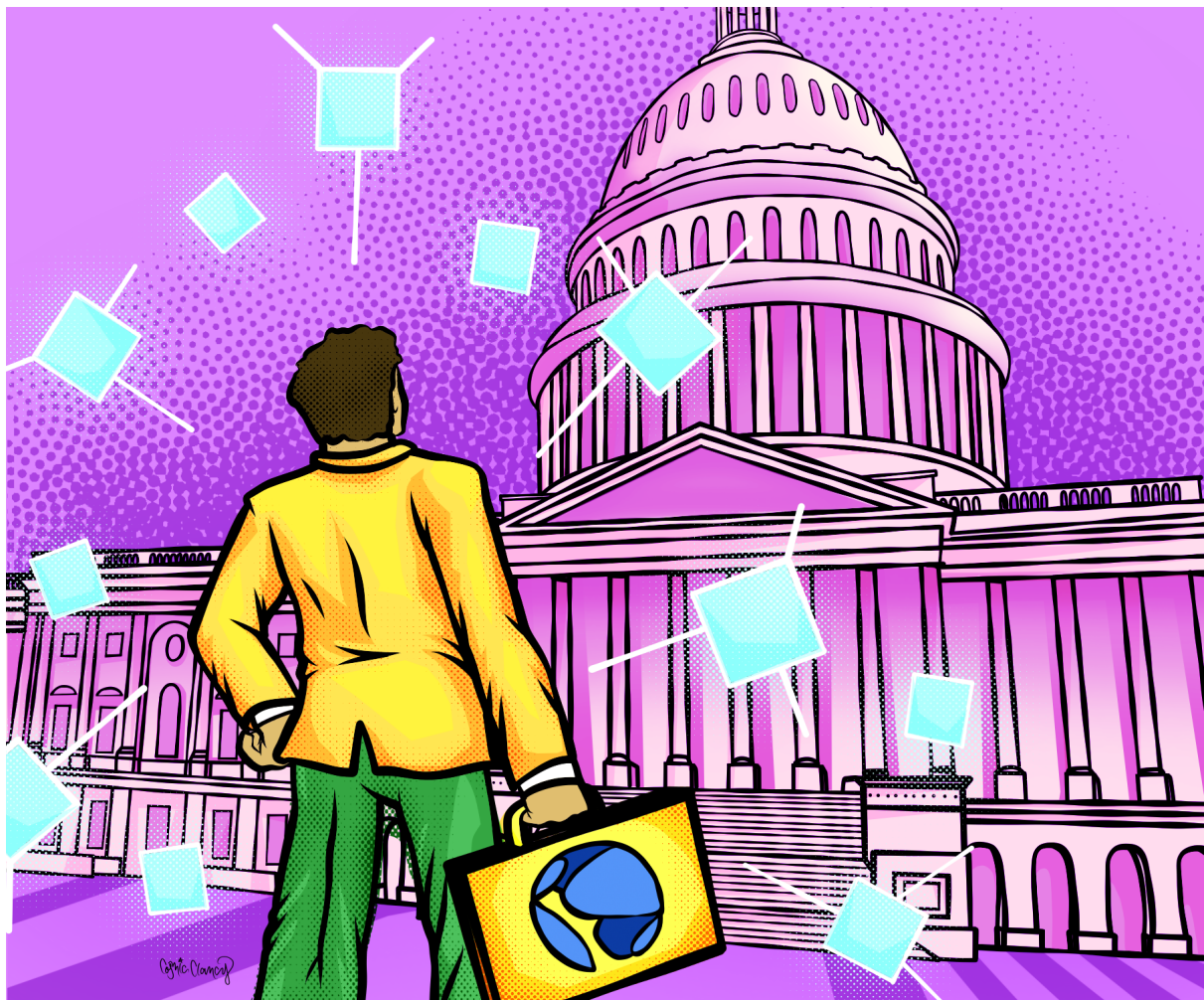
Decentralized Law

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UMA: Making financial markets universally accessible

Defending Crypto Projects with Marc Goldich

Credit: Cosmic Clancy

Please tell us about your background and how you came to specialize in crypto-legal issues.

Firstly, I must start by saying, thank you for reaching out. I thoroughly enjoy the Bankless newsletter and am happy to be in the company of the other subjects who have participated in a *Decentralized Law* interview. Secondly, this is my caveat for everything I say here: I am not one to give (or take) career advice, as I believe survival bias can skew outcomes and that no two paths or circumstances are ever the same, so readers should understand my story is just that; one man's story.

That said, my journey to crypto law is unique so hopefully your readers will find it interesting. I began my career at the international law firm of Reed Smith, where I spent over a decade representing some of the largest companies in the world in complex litigation and regulatory matters. From representing companies in

high-stakes regulatory enforcement actions to bet-the-business international disputes, I was charged with advising clients on the best course of action and representing their interests in court. I found this work to be mostly engaging and fun.

Although life in Biglaw is not easy and there isn't much job satisfaction in general, I managed the better part of a decade happily serving clients and working with a small group of trusted colleagues and friends in an otherwise traditional law firm setting. Ultimately, however, the work became monotonous and mundane, and I realized that being a part of that highly bureaucratic world was not sustainable for me. I sought a greater purpose and more autonomy to be entrepreneurial.

After 11 years, I left Reed Smith to manage a class action and whistleblower practice at a Philadelphia plaintiffs firm with a national presence. I then opened my own class action and whistleblower law firm with Noah Axler (currently of Anderson Kill), a frequent opposing counsel for whom I had a great deal of respect from my time defending financial institutions in class action lawsuits (brought by his clients). We mostly specialized in class action and whistleblower cases, litigated our cases in courts all around the country, and recovered tens of millions of dollars for clients nationwide. It was fun and meaningful work, but the class action business is very mature and slow moving.

In 2017, to diversify our interests, we started getting into the fast moving and intellectually stimulating crypto industry and began exploring the intersection of blockchain technology and litigation finance. This resulted in our founding in 2018 of LawCoin, the parent of the blockchain-based litigation investment platform, Dejure.io. We shortly thereafter became a ConsenSys portfolio company and it was our participation in the ConsenSys Tachyon accelerator program and our work on that project (including completing the first-ever tokenized litigation finance investment) that really thrust me full speed into crypto.

In parallel with all of that and with litigating our ongoing legacy cases, I continued to dive deeper into the space, growing Axler Goldich's crypto law practice and engaging in crypto-law community-building and lively discourse with other crypto lawyers at the forefront of the industry. Having swallowed the red pill in its entirety, and after nearly two decades representing clients in all types of industries, I recently retired from private practice to become General Counsel of Terraform Labs.

What should a crypto lawyer keep top-of-mind when working with clients in the crypto space?

You will never be the smartest person in the room. Do not overcompensate once you inevitably realize this truth. I say this in jest but, seriously, there are true giga brains working in this industry. This means that you must understand their needs, speak their language, and offer practical and pragmatic legal counsel while, at the same time, not let them pull the wool over your eyes or skip over important details for want of better understanding of the tech.

Crypto lawyers should also recognize that they are often only going to be one input in a decision tree. This is still a nascent industry with a lot of uncertainty, legal and otherwise. As lawyers, we do our best to present our clients with an analysis of risks and counsel them about the likelihood of negative consequences from taking any course of action by weighing the remoteness and severity of said risks. The difficulty in crypto is that the technology does not fit neatly into the legacy regulatory framework, and—notwithstanding oversimplification and misunderstandings of the tech—this is why lawyers who understand both the tech and the industry serve an important and valuable role.

What should a crypto lawyer avoid when engaging with crypto-related projects? How do you spot red flags?

As per above, if you find you are the smartest person in the room, don't take those clients. Jokes aside, when I was in private practice, the biggest red flags were probably the following: (1) projects hopping from lawyer to lawyer seeking an answer they want as opposed to the answer or advice they are being given; and (2) projects that have no real reason to utilize blockchain technology or tokens.

Sometimes projects find cute ways to say, "how do I do something illegal but make it look legal". You don't want those engagements. That said, by and large, founders in this space are good actors looking to do interesting things with exciting technology.

Due to the inherent features of the blockchain, do you think that larger crypto projects should be assisted by an international team of lawyers?

Undeniably, yes. By its very nature, this nascent technology intersects with global jurisprudence. Blockchain technology touches the contract, intellectual property, regulatory, and antitrust laws of jurisdictions all around the world. Indeed, the vast majority of blockchain transactions take place in an international context. Given the globalized nature of crypto and digital asset trading in general, there are a great number of governmental bodies seeking to exert jurisdiction over the space—often with drastically different views and strategies—and having competent counsel with an understanding of each jurisdiction's laws and regulations is vital to designing a thoughtful, and compliant, path forward.

Regulation

The European MiCA Regulation: A Friendly Model? - Part I

Credit: B(3,A)Rhunter

Author: *eaglelex*

This article presents a brief evaluation of the Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets (COM(2020) 593 final) (hereafter, "MiCA"). Part I, presented herein, will provide a general overview of MiCA and focus on the nature of so-called "utility tokens."

When assessing the MiCA regulation, it is necessary to consider the aims of the European Union (EU). The first and foremost aim of the EU is the creation of a single internal market, where businesses are free to move and to enter into relationships that are governed by a common set of applicable laws.

The digital revolution has brought an additional, ambitious aim: that of building a future-ready economy that works for the people. In this regard, the most innovative elements of European law are encompassed in the recent "digital finance package." In the words of the European Commission, the package aims to ensure that "*the EU embraces the digital revolution and drives it with innovative European firms in the lead, making the benefits of digital finance available to European consumers and businesses.*"

While the blockchain industry is global in nature, the risk is that the MiCA initiative is ultimately too narrow. MiCA's scope of application is merely regional, with rules, in principle, devoted to EU-located businesses. The ultimate measure of MiCA's success will be the model's adoption by other jurisdictions. These regulations must set high qualitative standards but also be able to work as a benchmark for non-European jurisdictions. There is precedent for this: the European General Data

Protection Regulation ([GDPR](#)), a European-centric law concerning online consumer privacy that has found [favor](#) in other jurisdictions.

In the world of blockchain-based businesses, however, the situation seems different. One aim of MiCA is the protection of investors and consumers, but it is crucial to avoid creating rules which are potentially detrimental for European businesses. The challenge MiCA must address is the need to foster innovation and attract investments in technology while ensuring that blockchain-based businesses don't exit Europe in favor of friendlier jurisdictions.

MiCA covers 5 different areas (Art. 1):

- transparency and disclosure requirements for the issuance and admission to trading of crypto-assets;
- the authorization and supervision of crypto-asset service providers and issuers of asset-referenced tokens and issuers of electronic money tokens;
- the operation, organization and governance of issuers of asset-referenced tokens, issuers of electronic money tokens and crypto-asset service providers;
- consumer protection rules for the issuance, trading, exchange and custody of crypto-assets;
- measures to prevent market abuse to ensure the integrity of crypto-asset markets.

According to the Commission, the proposed text seeks to "*provide legal certainty for crypto-assets not covered by existing European financial services legislation and establish uniform rules for crypto-asset service providers and issuers at European level.*" The scope of application of MiCA should therefore be residual in nature, as it does not apply to crypto-assets that qualify as financial instruments (Art. 2).

This is very good news from the perspective of U.S. lawyers accustomed to dealing with the wide scope of the *Howey* test in matters related to cryptoassets. Finally, we have proof there is a space in which securities laws do not apply—where cryptoassets are just cryptoassets!

Yet the question remains: which kinds of tokens are not considered a security? MiCA devotes many rules to two types of tokens:

- "asset-referenced token," defined as a type of crypto-asset that purports to maintain a stable value by referring to the value of several fiat currencies that are legal tender, one or several commodities or one or several crypto-assets, or a combination of such assets.
- "electronic money token," defined as a type of crypto-asset the main purpose of which is to be used as a means of exchange and that purports to maintain a stable value by referring to the value of a fiat currency that is legal tender.

Asset-referenced tokens are a broad category of stablecoins and other types of commodity tokens, such as DAI. Electronic money tokens, conversely, are tokens

that are pegged to a single currency, e.g. USDC or USDT. Tokens which are not financial instruments are less clearly defined by MiCA. The only clear definition concerns the so-called "utility token," defined as a type of crypto-asset which is intended to provide digital access to a good or service, available on the distributed ledger, and only accepted by the issuer of that token.

The attractiveness of the MiCA proposal largely concerns utility tokens, which is why its framework should be carefully assessed.

Such "utility tokens" have non-financial purposes related to the operation of a digital platform and digital services and should be considered as a specific type of crypto-asset. Some scholars argue that utility tokens also provide holders with governance rights in the issuing organization, such as the right to vote for updates in the functional structure, and otherwise shape the future of the organization. A utility token which meets one of these definitions is not usually considered a traditional security or financial product; its aim is not to create future cash flows but rather to enable interaction with a blockchain-based ecosystem.

The most prominent example of a utility token is Ether. Besides being a cryptocurrency (Ether tokens can be used to directly transfer value), the token also enables functionality on Ethereum's decentralized computing and smart contract platform. Users can pay transaction fees (gas) with Ether and interact with other tokens on the network using Ether. Another example which is often mentioned is "Filecoin," which functions as a reward for users providing storage space to the network and can be spent to store and retrieve data thereon.

Of course, even tokens that function as utility tokens will typically have an investment component, as these tokens can be traded on centralized or decentralized exchanges. Therefore, most utility tokens are a hybrid of finance and function.

From a different perspective, pure utility tokens (when abstracting them from any investment component they may have) are not comparable with shares in companies, partnerships, or other entities. Utility tokens do not confer ownership in an underlying company but to a certain extent, they often grant membership in the blockchain-based platform. The aim of the membership is not to generate future cash flow, which vastly differs from the model of shares in a corporation. For instance, a shareholder of a U.S. listed company does not have any conferred right to consume the product created by the company, whereas this is exactly the function of a utility token.

MiCA does not address the problem of the dual nature of the utility token. The issue has been discussed in literature but is not directly tackled in the proposal. It is argued that if utility tokens encompass significant investment components, they could be subject to securities regulations.

Utility tokens are subject to disclosure duties, which are encompassed in Title II of MiCA, while asset-referenced tokens and e-money tokens are subject to a licensing and authorization requirement, as well as certain operating conditions.

Art. 4 MiCA does contain some issuer requirements. The issuer should be a legal entity residing inside or outside of the European Economic Area. For issuers established outside the European Union, jurisdiction lies with the competent authority of the Member State, either where the cryptoassets will be offered or where the admission to trade on a platform is initiated. The issuer in these cases must draft a "cryptoasset white paper" that complies with Art. 5 MiCA and give notice of that white paper to the competent authority. Moreover, the issuer must ensure that funds provided to the cryptoasset offering are safeguarded and segregated. Additionally, the issuer must comply with basic conduct of business rules laid down in Art. 13 MiCA. Finally, any marketing materials must be clearly marked as such and refer to the white paper.

The MiCA disclosure, conduct, and liability rules relating to the white paper are similar to the financial instruments prospectus requirements set forth by European law. The aim of these rules is to address the inadequate disclosures, misrepresentations, and fraud sometimes observed in certain ICOs. In return for MiCA compliance, white paper issuers benefit from a "European Passport" concerning the issuance of cryptoassets (Art. 10 MiCA). The Passport works as proof of compliance and should foster a safe single European market for the token industry.

A significant difference between the financial instruments prospectus and the white paper is that the latter is not subject to preliminary approval by supervisory authorities. The white paper is required to be posted with the competent national financial authority twenty days prior to the offering and the competent authority has the right to intervene before and after the offer is under way. Competent authorities are therefore allowed to carry out supervisory functions before and after the publication of the white paper. The European Commission justifies this rather unusual approach (compared to rules on financial instruments) by pointing out the need to avoid an excessive burden upon competent authorities.

On the basis of these first impressions of MiCA, it is possible to discern strengths and weaknesses in the overall approach to the legal classification of tokens. It is certainly a positive outcome to regulate tokens which are not considered financial instruments. In addition, defining a utility token can advance technological innovation in many different sectors.

Nevertheless, uncertainties remain regarding this regulatory approach. The category of cryptoassets which are not financial instruments, asset-referenced tokens, or electronic money tokens is not clearly defined, but only addressed as a residual catch-all category. In this framework, the categories of asset-referenced tokens and electronic money tokens do not adequately represent what the industry is actually offering. It would have been better to adopt three distinct categories—payment, investment, and utility tokens. Moreover, it is not clear which of the existing market venue rules will apply to circulation of tokenized financial instruments.

Part 2 of this article will appear in the next issue of Decentralized Law.

Developments

Decentralized Courts: A Legitimate Solution?

Credit: B(3,A)Rhunter

Author: *lion917*

Blockchains, cryptocurrencies, and NFTs continue to make headlines because of the recent crackdown in China and the proposed legislations in India and the United States. A commonly held view is that governments dislike cryptocurrencies for taking away their economic sovereignty. However, cryptocurrencies also challenge the basic norms of governance, primarily the adjudication of disputes. The recent creation of decentralized courts—an automated dispute resolution mechanism that allows outcomes to be enforced through smart contracts on a blockchain, will dilute but not entirely eradicate the government's control over its judicial system.

In May 2021, a Mexican Civil Court upheld and enforced an arbitration award which was obtained through proceedings governed by the popular blockchain dispute resolution tool Kleros. The real estate dispute was submitted in October 2020 and within a month the three adjudicators unanimously decided the outcome. The arbitrator affirmed their decision and the winning party's motion for enforcement was upheld by the Mexican court without reservation, demonstrating that decentralized courts can be recognized by traditional legal systems as efficient mechanisms for dispute resolution. However, these courts will not meet their full potential unless they become a self-sufficient legal system which can function without needing subsequent ratification.

Kleros was one of the first open-source Web3 opt-in dispute resolution systems built on the Ethereum blockchain. Kleros uses crowdsourcing and incentivizes participants using principles of game theory to adjudicate disputes efficiently, equitably, and reliably. When a dispute is submitted by parties to Kleros, a panel of jurors is selected randomly from a larger juror pool. To be eligible, jurors must have

staked Pinakion ([PNK](#)), Kleros' native [token](#). Each juror assesses the evidence submitted, and registers a non-public vote. If a juror's vote is in consensus with the majority vote, the juror keeps the staked tokens; if in the minority, the juror forfeits their tokens. Additionally, those jurors who voted with the majority are rewarded with the forfeited tokens and the tokens that are charged as arbitration fees. This practice creates economic incentives for jurors, encouraging them to seek consensus.

[Jur](#) and [Aragon Court](#) are two similar blockchain-based dispute resolution mechanisms that provide decentralized adjudication. As with Kleros, in Aragon Court the amount of tokens staked is directly proportional to the probability of being drawn as a juror. Malicious voting is discouraged because each juror knows that inconsistent voting will likely lead to the loss of staked tokens. Decentralized courts often have more than two levels of appeals, with the number of jurors increasing exponentially at each appellate stage. Thus, the cost of dispute resolution increases proportionally to the probability of multiple appeals. While most decentralized-courts were designed to adjudicate real life disputes and escrow agreements, many leading decentralized-courts are looking to revamp their systems to accommodate the rise of Decentralized Autonomous Organizations (DAOs).

For example, [Aragon](#) is a leading DAO tooling platform which pairs these tools with their dispute resolution services. On their own, most decentralized courts don't have a profitable revenue model and as such must co-exist with a broader service. Additionally, the use of the staking model in decentralized courts leads to high transaction costs due to the current reliance on the Ethereum blockchain, meaning the use of this model is cost prohibitive for some due to the excessive gas fees. To keep decentralized courts accessible to all, an insurance-like product should be explored to offset the costs of decentralized adjudication by permitting parties to pay a small fee to a decentralized court or service at the time of drafting the dispute resolution clause in an agreement.

In addition to high transaction costs, practical use cases are limited. The use of decentralized courts is limited to technologically savvy users. Since there are no particular eligibility requirements to become a juror, disputes with nuanced legal issues may not be resolved; decentralized courts are most effective when resolution of the dispute involves answering simple yes/no questions. In practice, use cases are limited to civil disputes, as it is unlikely that users will put their faith in these systems for resolving complex criminal and constitutional cases. In addition, sovereign governments will not readily concede their implied rights over constitutional and criminal proceedings.

Although use cases are currently limited to commercial disputes where the parties can afford the transaction costs, it seems very likely that decentralized courts will grow alongside DAOs and blockchain-based protocols that they are most suited to serving. Questions of legislative and constitutional interpretation and the resolution of criminal proceedings will likely remain the sole province of the traditional court

system for the foreseeable future. But as we are learning, the future can arrive more quickly than we think.

NFTs: Securities? Freil vs. Dapper Labs

Credit: B(3.A)Rhunter

Author: *Terumask*

In a few years, when we look back at the 2021 bull run, we will undoubtedly remember the hype about non-fungible tokens (NFTs). NFTs have found favor as an innovative solution for tracking digital asset ownership using the blockchain. But as with most innovations, NFTs have brought forward legal challenges.

In May 2021, one of the first lawsuits involving NFTs was filed in the New York State Unified Court System. NFT buyer Jeeun Friel sued Dapper Labs, the developer behind CryptoKitties, for selling an NFT collection known as *NBA Top Shot Moments* (NBA Top Shots) without complying with the Securities and Exchange Commission (SEC) and federal securities laws. The plaintiff alleged this failure to comply caused significant damages to retail investors lacking the technical and financial expertise to correctly assess the risk.

NBA Top Shot offers Moment™ collectibles: NFT's which feature video footage and associated statistics for a particular highlight moment in an NBA player's career. According to the NBA Topshots website, more than 600,000 NBA fans own a collectible.

Whether an offering is considered a security is determined by the Howey Test (SEC v. W.J. Howey Co). This test defines securities as (1) an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the efforts of others. In *Friel v. Dapper Labs* the plaintiffs allege that the Howey test applies to the NBA Top Shots NFTs.

In the case of NBA Top Shots, the NFTs were sold in packs or on their marketplace, leaving no doubt that the NFT purchase required an investment of money and therefore meets the first element of the Howey Test.

When it comes to determining whether or not NFTs are an investment in a common enterprise, the lawsuit uses two arguments: (1) with digital assets, the common enterprise usually exists because "the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter's efforts" (SEC Framework); (2) in NBA Top Shot, Dapper Labs controls the enterprise and makes the decisions, linking the profits or losses of Dapper Labs with the profits or losses of NBA Top Shot owners.

By definition NFTs are unique and non-interchangeable, so it could be difficult to prove that each's value is dependent on the others in a collection. What may be easier to prove is the second argument for common enterprise: that there is a link between the profits and risks of Dapper Labs and those of NBA Top Shot owners. In this case, it can be argued that there is a direct link because of the fact that Dapper is able to set and collect a percentage fee on every transaction. The higher a selling price, the more income Dapper receives. In this way, the fortunes of both parties are connected.

This doesn't mean that a common enterprise exists for every NFT. For example, in instances where an artist mints an NFT and sells it without assigning themselves the right to future royalties, their profits are only drawn from the initial sale and there is no ongoing financial relationship between the artist and NFT owners.

In the third element of the Howey Test presented by the lawsuit, which relates to the expectation of profits, the plaintiffs claim that NBA Top Shot owners and Dapper Labs can generate profits from the capital appreciation of each asset, arising from market demand and facilitated by secondary markets where holders can resell their NBA Top Shot.

It is true that some buyers purchase NFTs with the mere intention of owning them as a unique collectible, in the same way that people collect baseball cards or paintings. Other purchasers are speculating that they can return a profit upon the resale of the NFT. Where ownership of an NFT includes royalty rights or where purchasers acquire NFTs subject to a hidden reveal, it can be more straightforward to confirm the buyer's expectation of profits. This could be the case with NBA Top Shot, due to the fact that people buy the packages without knowing which NBA Top Shot is inside, which could reinforce the idea of speculation.

Finally, the last Howey Test requirement is that the expectation of profits should be based on the effort of others. On this point, the lawsuit alleges that: (1) Dapper Labs

controls the [Flow](#) blockchain, which is essential for the existence of the NBA Top Shot; and (2) that they can make marketing decisions that increase NBA Top Shot hype, which would increase the demand. The key question here is: does the price change because of Dapper Labs' market decisions or because of supply and demand in the market, and are these factors inextricably linked? Because Dapper Labs operates a centralized platform where it can maintain control over the market, it is clear we can recognize their impact on the NBA Top Shot prices.

As we can see, whether an NFT meets the definition of a security is far from clear-cut and should therefore be determined on a case-by-case basis. It will be very interesting to follow the outcomes of the Dapper Labs case and similar lawsuits to see how the courts decide on this issue.

Corporate, DAO, Governance! An Antithetical inquiry?

Credit: [B(3.A)Rhunter](#)

Author: [*Cheetah*](#)

Traditional corporations have proven themselves as effective vehicles for organizing businesses, particularly in relation to aspects such as governance and legal structures. Corporations are governed through a legal framework that protects the interests of its owners, managers, and shareholders. This is called [corporate governance](#). Corporate laws mandate horizontal fairness via rules on participation such as quorum, information rights, and tag-along triggers. Corporations rely on vertical agency constructs to govern themselves, whereby trust is placed in agents such as the Board of Directors (BoD) or key managerial personnel to make decisions in the shareholders' interests.

This trust, since it's centralized, may often give rise to misbehavior or opportunistic conduct (e.g. [self-dealing](#)). The placement of such trust is often justified using the

argument that shareholder [value-maximization](#) is easier with centralized decision making. Jurisdictions try to mitigate the tendency towards self-dealing by detailing norms for shareholder protection, the role of the board, and by imposing rigorous transparency and disclosure requirements. However, problems are pervasive and persistent and a true balance between the interests of all parties is rarely achieved.

Enter Blockchain and DAOs

Blockchain technology offers a unique solution to the pitfalls associated with traditional corporate governance: centralized concentration of power, hierarchical decision-making, and human fallibility. Blockchain-based [governance](#) reduces or eliminates the need for trusted intermediaries—replacing them with member-managed code. Code is law in blockchain, after all (a position not without controversy!). The birth of smart contracts, which are essentially self-executing computer programs, has given rise to a new type of organization—the decentralized autonomous organization, or DAO.

A DAO is a group of individuals, typically organized around a common mission, who organize themselves and build consensus that ultimately manifests with on-chain governance and financial transactions. In a DAO, the chances of financial misbehavior and collusion are significantly lowered as matters are governed by code. For instance, financial transactions are typically on-chain and transparent to all, leaving little room for fraudulent activities. In a DAO, there is no BoD, suite of executives, or other nodal authorities that dictate the decision-making. DAOs use technology to create flatter organizational structures. DAOs typically issue governance tokens to facilitate decision making, and these token-holders vote on projects and proposals in a democratic process that is truly transparent!

The chief advantage of a DAO, therefore, is that the uncertain human element is replaced with objective, self-executing code that is independent of personal trust. There are other perceived advantages to DAOs as well. First, they are flexible because the flow of information is optimized through dynamic feedback effects. Consequently, DAOs are more attack-resistant and can grow rapidly. Second, they can be much more efficient in relaying and relying on local knowledge and circumstance because information is less siloed. The distribution of power confers more flexibility and autonomy to the members of the DAO and offers enhanced options for a structure with interacting domains of expertise. In contrast to the typical corporate structure, DOAs are downright revolutionary organizations.

Pitfalls of DAO Governance

This sounds too good to be true, right? What's the catch? To start with, aligning incentives with governance is an ongoing problem across all structures, and DAOs are no different. Voter apathy is universal, it seems. For members to maximize their utility for the organization while aiding the mission of the DAO, proper incentivization

is necessary. In the absence of that, opportunistic actors will sooner or later game the governance design. Further, there is the problem of concentration of active voting power. In any given DAO, there are those who hold a substantial share of the native-governance tokens. As has been the case with many decentralized protocols,such outsized holdings can create unfavorable outcomes. This situation is aggravated by the incentive problem which causes low voting participation on the chain. Lastly, if the users of the network are non-token holders, there might be a misalignment of interests with the DAO.

Furthermore, the lack of default rules regarding DAOs creates unintended gaps within the governance frameworks executed by smart-contracts. Corporate laws across jurisdictions have mandatory or default rules which act as buffers in uncertain and novel situations. Because of these default rules, contracting parties are spared the hassle of accounting for every single eventuality in their relationship. In the case of DAOs, although model governance rules have been written, no jurisdiction has yet enacted such model rules in any way comparable to model rules for traditional business entities. Some argue that at least in the case of DAOs, such rules are less likely to provide any guidance at all.

It is possible for the founders of a DAO to opt-in to an already-existing legal entity framework, but that is hindered by the current technology-averse legal infrastructure which relies on natural language (and not code deference). But choosing to remain outside of a legal wrapper exposes DAO members to unlimited liability. Extant corporate law would seem to characterize DAOs as a general partnership where each partner, or in this case a DAO member, would be jointly and severally liable for the debts and liabilities of the DAO. The newly enacted Wyoming law offers a solution to the liability issue by layering limited smart contract governance provisions atop of a Limited Liability Company framework, but legal uncertainty remains in most other jurisdictions.

The legal and governance issues faced by DAOs will be remedied in time. DAOs may adopt dynamic governance where regulatory supplements may plug gaps in the code. Further, DAO members could be incentivized with indirect monetary gain with innovative governance models, such as those involving staking. Other on-chain governance models (e.g. Tezos, Dash, Cardano, Maker) and reputation-based governance solutions may be explored as well.

Reforming Corporate Governance?

Will traditional companies adopt some of the internal practices of DAOs? DAO members are subject to a different agency relationship as they are generally free of a central authority or corporate hierarchies. DAO members work in a dynamic set of personal relationships that are self-organizing. While DAOs don't normally rely on external incentives such as regular wages or common-law duties of good-faith, a rationalist argument is that DAO members often unify to optimize the DAO to

increase the value of its governance token. Quite simply, if an optimization offers value to the token holders, it will be pursued.

These are crucial breakaways from our current organizational structures which are centralized and burdened with onerous fiduciary duties. Line up the incentives and the need for fiduciary oversight decreases. Only time will tell whether DAOs replace traditional corporations. However, one thing is certain: DAOs are testing the effectiveness of these corporations' traditional structures and the law will need to keep pace.

Taxation

Taxation: U.S. Tax Considerations and Questions Raised by ConstitutionDAO

Credit: B(3.A)Rhunter

Author: *taxpanda*

For a few days, the cryptoverse and the real world collided when ConstitutionDAO bid for and nearly won an original copy of the United States Constitution. Having raised nearly 50 million USD in the span of about a week, ConstitutionDAO had an on-chain war chest and became an early favorite to win the auction which was hosted by Sotheby's. ConstitutionDAO was outbid at the last second by a multi-billionaire investor and hedge fund CEO. According to Sotheby's, the winning bid of 43.2 million USD broke the record for the highest price paid for a historical document sold at auction.

ConstitutionDAO made history, but the fact remains that they lost the auction. Post auction, the core team was tasked with the administrative burden of working out what to do with the unused funds. After some deliberation over which direction to take the DAO, the core team decided to wind down the project and offer refunds to

those who contributed. These were to be available via Juicebox, the smart contract platform used for the initial fundraising. The ConstitutionDAO website provides two options for the refund: claiming ConstitutionDAO's native-governance token, PEOPLE, or redeeming PEOPLE for ETH at the original purchase ratio of 1 ETH : 1 million PEOPLE, minus gas fees.

As with many crypto-related projects, everything with ConstitutionDAO happened very quickly. Many legal and logistical questions remain as its affairs continue to wind down, including many tax-related questions. The ConstitutionDAO website clarifies that "ConstitutionDAO cannot and will not endorse any future plans for the token." Additionally, admins in the ConstitutionDAO Discord server have since announced plans to launch a new "We the People" token for any potential future projects.

Despite these statements, a secondary market formed for PEOPLE, and shortly after the auction many people were able to make a profit from selling their PEOPLE on decentralized exchanges. For those who took advantage of the surge in value of PEOPLE, remember that those transactions are likely taxable short-term capital gains for U.S. tax purposes, based on the fair market value of ETH at the time those tokens were purchased and the fair market value of the property/cryptocurrency received when the tokens were later sold.

To date, just over half of the total funds have been claimed as refunds, meaning that millions of dollars still sit in the smart contract. It's possible that the more crypto-savvy participants are waiting to reclaim their funds, whether that's because of high gas fees or generally not being in a particular hurry to be refunded because they've already aped into new projects and have completely shifted their attention for the time being.

However, a significant amount of the remaining funds are likely to be relatively small contributions (the median donation size being about 200 USD) by non-crypto-native folks who are now finding that they might have to pay more in transaction fees than the amount they originally contributed. If you're in the latter category, don't be discouraged. You may still be able to take advantage of a loss for U.S. tax purposes, for example, by using the capital loss to offset capital gain (subject to those specific rules). Even if the amount of the contribution seems relatively small, the refund must actually be claimed in order to determine what the tax effect would be.

Still, there's no guarantee that all of the funds will be refunded, and it appears that refunds not claimed will stay in the smart contract forever. Presumably, for example, someone could remember ten or fifteen years from now that they contributed ETH to ConstitutionDAO, go back to the ConstitutionDAO website, and claim their refund. I'll admit that I don't know much of the details about how the actual smart contract that

ConstitutionDAO implemented with Juicebox is written, specifically the refund feature (I'm a TaxPanda, not a DevPanda), but I would be interested to know how much control over these non-refunded amounts the smart contract allows Juicebox, ConstitutionDAO, or both, to have. For example, is there any way that either ConstitutionDAO or Juicebox could decide in fifty years that anyone who would have ever claimed a refund had already done so, and donate the remaining amount to charity or a different project? Could ConstitutionDAO have somehow received the entire amount of the funds and distributed them back to contributors itself?

Questions like these are mainly important in order to determine the tax effect on the organizers themselves, i.e., ConstitutionDAO and Juicebox. As a result, it's even more important for anyone who is planning and developing projects with similar fundraising scale to keep these questions in mind and understand the implications of potential outcomes, from how the smart contract is written to what legal entity should be used (quick TaxPanda Note: ConstitutionDAO formed an LLC and considered the possibility of becoming a "501(c)(3)" tax-exempt organization for U.S. tax purposes. Non-profit organizations and tax-exempt status for U.S. tax purposes will be discussed in more detail in a later issues, but a quick PSA as the end of the year approaches: consider that there are opportunities to make donations with crypto, which could result in charitable contribution deductions that may lower your U.S. tax liability).

Ultimately, ConstitutionDAO did not win the auction and critics jumped at the opportunity to label the attempt a complete failure. However, despite the negative criticism, the unsuccessful result at the auction, and some of the remaining issues that still need to be resolved, both crypto- and non-crypto-native people can and should appreciate that there is a thick silver lining: ConstitutionDAO's valiant effort created opportunity and gave people equal footing in an area typically reserved for the elite few, shedding more public light on the power and potential of blockchain technology, cryptocurrency, and the crypto-community.

Img Link: https://bankless.cc/UMA

UMA: Making financial markets universally accessible

News and Selected Articles

Credit: B(3,A)Rhunter

Real Estate Has Gone Meta

Author: *Adam Clark Estes*

Key Insights:

- Metaverse Group recently bought a parcel of land in the virtual world Decentraland for approximately 2.5 million USD. It is expected that the plot of land will be developed as a fashion and retail hub. Major fashion brands such as Louis Vuitton have expressed interest in the metaverse with virtual wearables becoming more popular as brands are seeking to bridge the gap between traditional retail and Web3.
- Recent years have seen millions being poured into digital assets. Akin to the real estate boom in New York, the virtual land grab is propelled by the expectation of huge financial returns in the future. From virtual concerts to shopping malls to leases and ad-selling, virtual real estate owners are well-placed to cash in on immense demand.
- Media conglomerates such as Meta (formerly Facebook) will no doubt try to muscle in on the metaverse with their financial might. A number of other companies have created metaverses such as Upland and Sandbox, attempting to capture the users before this happens.

Capitol Hill Warms Up To Crypto

Author: *Andrew Chow*

Key Insights:

- A major congressional hearing took place before the U.S. House Committee on Financial Services. The hearing stems from the Securities and Exchange Commission's (SEC) call for more expansive regulation of cryptoassets. The newly appointed SEC Chairman, Gary Gensler, has expressed a negative attitude towards cryptoassets.
- Led by Maxine Waters, the Chairwoman of the House Committee on Financial Services, six witnesses were deposed before the Committee. The witnesses are from major crypto players such as Coinbase, Circle, and FTX.
- The Committee focused much of the hearing on stablecoins, such as USDT and USDC, with related testimony helping to clarify the difference between various stablecoins as well as their relation to Central Bank Digital Currencies, which are government-issued digital currencies.
- Unlike most hearings in recent years, the hearing was not split along party lines, with members from both sides of the aisle showing a common interest in better understanding cryptocurrencies while being skeptical of their application.

On Crypto Bill, More Changes Likely, Government Goes Slow: 10 Points

Author: *Sunil Prabhu*

Key Insights:

- India's Cryptocurrency Bill will not be discussed in parliament yet, and more changes are possible before consensus is sought.
- The Indian government has reassured citizens that while they are in favor of reasonable regulation which aligns with global trends, they are not willing to rush the legislation.
- This source has previously reported that the government is planning to regulate cryptocurrencies as an asset class, effectively banning people from using crypto as a currency or method of payment.
- If this is correct, cryptoassets will be regulated by the Securities and Exchange Board of India rather than the Reserve Bank of India.
- The Bill also is expected to establish a framework for distributed ledger technology and to lay the groundwork for creation of a Central Bank Digital Currency, issued by the Reserve Bank of India.

Insuring Crypto: The Birth of Digital Asset Insurance

Author: *Adam Zuckerman*

Insights:

- In 2019, a record twelve crypto exchanges were hacked, and an estimated 4 billion USD worth of cryptoassets were stolen globally. In response, insurers have begun selling "digital asset insurance" to provide coverage for those holding large amounts of Bitcoin or other digital assets (also referred to as cryptoassets).
- There are several shortcomings in the new industry, including the problems associated with the regulatory landscape, the lack of transparency for consumers, and the significant amount of bias around the crypto industry.
- Companies seeking digital asset insurance should explore captives, an insurance company wholly owned by the insured, as an alternative solution to informal self-insurance or traditional third-party insurance. Moreover, insurers could serve as a *de facto* regulatory force in the digital asset storage industry, positing that insurers would be a more effective regulator in the space than the government itself.

[Regulating Libra: Will Legal and Regulatory Uncertainty Prevent the Launch of Facebook's Cryptocurrency Project?](#)

Author: *Amanda Simmons*

Insights:

- In June 2019, Facebook's co-founder and CEO, Mark Zuckerberg, announced the launch of a new cryptocurrency, Libra, by releasing a white paper entitled "An Introduction to Libra." The new project's stated mission was "to enable a simple global currency and financial infrastructure that empowers billions of people." Within days, politicians called for Facebook to halt the project, insisting that it was incumbent upon policymakers to understand Libra and its unprecedented impact on the global financial system before the project could proceed.
- The paper examines the regulatory hurdles facing the Libra project and assesses the likelihood that the project will launch. It provides a detailed overview of the Libra project, including a discussion of its key features: the Libra Blockchain, the Libra Reserve, the Libra Association, and Calibra, the digital wallet application which will be embedded within Facebook.
- With an understanding of the basic functionality of Libra, the paper further provides an analysis and application of international and domestic regulatory frameworks relevant to the Libra project. Specifically, it covers the broad international regulatory landscape facing the Libra project, assuming that cryptocurrencies are fundamentally international, indeed "borderless."

From NFTs to CBDCs, Crypto Must Tackle Compliance Before Regulators Do

Author: *Jonathan Camilleri Bowman*

Insights:

- With the boom in NFTs and rise of the metaverse, 2021 was undoubtedly a milestone for the cryptoverse. However, three fundamental issues need to be addressed before the mainstream acceptance of crypto: Anti-Money Laundering (AML), Know Your Customer (KYC) and Combating the Financing of Terrorism (CFT).
- **Money-laundering**: the explosion of the NFT market has shown the need for implementation of KYC. To avoid an early demise of the crypto industry, KYC norms ought to be adopted proactively.
- **Compliance as a service:** with NFT platforms hesitant to implement protections, technology platforms ought to develop tighter protocols before a government crackdown. Companies can also adopt this as a growing service and an internal solution in the industry.
- **Clear KYC/AML norms for crypto viability:** El Salvador's Chivo wallet was plagued by security concerns, warranting adoption of KYC best practices. While different countries are at varying stages of implementing protections, clear guidelines are emerging. To have an internationally recognized standard, the industry should be proactive and acknowledge the pitfalls of the current system.

Russia to decide between blanket crypto ban and legalizing exchanges in 2022

Author: *Zhiyuan Sun*

Insights:

- On December 16, 2021, conflicting reports emerged in Russia on the state of crypto regulatory affairs, which may indicate that the world's largest country by area, whose population's annual volume of cryptocurrency transactions is about $5 billion, has reached a crossroads on crypto regulation as it enters 2022.
- On the one hand, Reuters, supported by statements from two anonymous financial market sources close to the Russian central bank, reported that the central bank wants to ban investments in cryptocurrencies in Russia, seeing risks to financial stability in the rising number of crypto transactions – which would align with remarks made by Vladimir Putin last month, who stated that cryptocurrencies bear high risks.

- On the other hand, on that same day, Anatoly Aksakov, chairman of the Duma's (Russian Parliament) Committee on Financial Markets, advocated for appropriate regulation of crypto exchanges and cryptocurrency mining, rather than an outright ban.

DAO Legal Tools

Kali - A LexDAO Multi-arm Jurisdiction Prototype

Author: *Drllau*

First was Morloch, which spawned a bunch of private investment ventures. However, due to securities law compliance, these typically are wrapped into traditional centralized firms. The many social enterprise and pure community DAOs are left in legal limbo (as noted by @cheetah above), treated with suspicion by banks for dabbling in cryptocurrencies and ignored by DeFi for being … not profitable. However recent attention pointed out the flexibility of unincorporated non-profit associations (UNA) as a low-cost alternative to trusts/foundations. LexDAO had already started on this journey 3 years ago and discovered a **surprising legal outcome**.

> Swiss Civil Code 210 Art 60 "Associations with a … non-commercial purpose **acquire legal personality as soon as their intention to exist** as a corporate body is apparent from their articles of association."

> US Revised Uniform Unincorporated NonProfit Association Act §2(8) "... members joined by mutual consent **pursuant to an agreement written, oral, or inferred from conduct**, for … nonprofit purposes"

The conclusion was inescapable, if carefully defined, a separate legal entity could exist on the blockchain, **THEN** formalize its existence by **acceding to off-chain civil authority** by filing, registering or licensing. LexDAO envisages spinning up a testnet

instance providing limited liability to members, with low cost voting to fine-tune the mission, constitution/by-laws, and tokenomics, then adopting conforming smart contracts and materializing in meatspace in any compatible jurisdiction. This is what our goddess Kali (currenting in alpha testing) supports.

[Core Voting Patterns]

[DAO governance Variations]

[concluding vision]