

Eric: [00:00:00] Welcome to The Encrypted Economy, where we look at the business of, regulation, and security for all things encrypted. Digital assets, blockchain technology, privacy, and smart contracts. Hope you'll join us while we explore these forces that are shaping the economy.

Hi, this is Eric Hess with The Encrypted Economy. You'll notice today, I am doing the whole episode by myself. Why? A couple of weeks ago, I spoke to Massachusetts Institute of Technology's, MIT's, computational law group about DAOs. We talked a bit about my testimony before Wyoming's Select Committee regarding their recognition of DAO's as LLCs underneath their regulations. And in fact, they just adopted that at the beginning of July. So, at any rate during it, I talked about briefly about Bitconnect and why I thought that was relevant to a discussion of DAOs. So, I'm going to expand a bit on that today. More of these types of episodes are going to be coming where I'm going to be delving into more the legal aspects of a different topics, as well as continuing to mix it in with my ongoing episodes.

So, what are we going to cover today? Today we're going to talk about what is a DAO. Why decentralization is important? Why it's important from a securities law context? What has some of the precedent and guidance been on decentralized autonomous organizations or just decentralized systems? As well as exploring the liability implications of DAOs, meaning who is ultimately going to be liable for DAOs?

And finally, we're going to talk a little bit about Bitconnect, which hopefully isn't a signal for how the SEC is going to be approaching theories of secondary liability with respect to DAOs in the future. So, we're going to start off with the DAO definition. DAOs, as you know, is a decentralized autonomous organization.

So, what is a decentralized autonomous organization? Decentralized autonomous organization has three components: it must be decentralized, autonomous, and an organization. So decentralized goes to the governance. What it means is that there is no singular managing entity or group of managers that are driving the management of the DAO.

So that means no president, no managing member, no general partner, none of the functions that you would normally see in the C-suite of the entity. Autonomous means that it's decentralized in the component parts. Now you can still manage the organization without the engagement of those managers. So, they're able to work independently, collectively rolling up into sort of the whole DAO structure, but not dependent on direction from any kind of management. Now, some people confuse autonomous with smart contracts or algorithmically managed, certainly smart contracts and algorithmically managed fits well into a data structure. Because if it's a smart contract, it's basically- it has an input, it has an output, it's code, it really functions completely independent of the organization. It just serves its purpose. But you can also have autonomous individuals. A human can be autonomous. You look at a lot of co-op boards. You look at condo boards. A lot of those people who vote on those act completely independent of one another, and there's no centralized structure and there's complete autonomy across its members.

And the last component of a DAO is an organization. So that organization can be just a group of people. If it's just a group of people or a group of organizations, but they're not protected by a limited liability structure, like a corporation or a limited liability company, then they're effectively potentially liable as individuals.

So, this was the impetus for Wyoming's enshrining DAO's within their LLC statute was to basically say, "Hey, we have a structure in place where DAOs can get the limited liability protection that we accord to other limited liability companies forming within Wyoming." And that's a drop in the context of an organization. I think a lot of the first DAOs were in fact, never incorporated. They're just a group of people working collectively. A good example of a decentralized organization, we can talk a little bit more about what it means from autonomy, but one that starts to look very similar is Bitconnect, but we'll talk about that a little bit later.

Bitconnect by the way, was not formed as a limited liability entity. Now centralized governance structures have their purpose, and DAOs aren't the answer to everything, but where there's fairly discreet software where the software or the function can be accomplished without centralized management, then why insert all the rent seekers in if it can be completely managed within the community.

So, when we're talking about DAOs, you don't even need digital assets or crypto to form a gal, but it does help it because. When we think about the way that digital assets interact with DAOs, it's probably important to start to think of it in terms of programmable money, because programmable money integrates very well with the types of code that are often housed within DAOs.

And this is just a trend. This is going to continue, and the regulators are obviously going to need to find a way to manage it, and not try to stop it, right? Let's say that you have a software program that generates wonderful imagery, and you own it. You could simply allow people to integrate with it and then have a programmable money. Where basically they purchase it with programmable money,

it goes into some sort of bot, they get the ability to create these images, and it's a completely decentralized process. That just one example of it, and I think it's also important to think of it in terms of a natural evolution from pure open-source software. So open-source software basically involves the licensing of code to an open community.

There's not necessarily payment involved. There may be certain restrictions. But it's largely made available for the whole community to use without necessarily all the conditions of confidentiality or even payment. And that's because, it's a way of getting broader community participation. But as a result, you have to give up a lot of the control and the money-making opportunity to get that community involved.

Maybe you do you have a separate support model later on where you're going to host that software, or you can provide support for that software, but effectively there's a break between the consumers of open-source licenses who may benefit and may contribute to it, and the ability to gain any kind of remuneration for that effort.

So, a DAO can resolve that because now if you create a DAO, and you create a way for programmable money to accrue to the benefits of those who are engaged in it, now you effectively have a model that's a little more suited to fostering the kind of innovation, but doing it in a way that's cost-effective where you're not having a full management involved on the other end. So, the benefit of the DAO is there's programmable money engagement of the user base, which you also could get in an open-source license and the ability to possibly create more sustainable, incentivized community associated. But decentralization in the context of DAO is important for another reason, the SEC is determination as to whether an instrument is a security or not and thus regulated by the SEC. The legal framework for that dates back to 1946, believe it or not to the Howey test, which we talked about a bit in our episode with Gary DeWaal back a few months ago. There are the primary elements of the Howey test, which would dictate whether or not an instrument needs to be regulated as security.

Is it an investment contract? Is it an investment contract where there is an investment of money in a common enterprise with an expectation of profit based on the efforts of others? Now there is more to it than that. I am overly simplifying it. In the context of a DAO who are the others that you would be relying on, who would be the contract with, in a decentralized organization.

So arguably if an organization is sufficiently decentralized, then it does not implicate the Howey test because it can't meet all of that criteria. In some cases that whole issue of decentralization, a sufficient decentralization might be questionable where let us say you have a very large VC backer who effectively has control, and you have a less engaged DAO community.

And maybe there is some argument there that they are using decentralization in a way to shield their control of the organization to avoid the application of securities laws. And in fact, in Gary Gensler's, May 26th testimony before the House Subcommittee on Financial Services. He did raise this point that asset managers could also find themselves a foul of the securities laws.

If depending on how they are engaging with these digital assets, this would certainly be one of them. If they have control, if there is, people are participating in the platform dependent on the engagement of the VC, and the direction of the VC, you could potentially satisfy all the elements of the Howey test with regards to a DAO, because maybe it is not truly a DAO.

And then there is another component of this, which is there's the securities component of it. But as the regulators look at DAO is there is always this lingering question of secondary liability. If you cannot identify who it is that's in charge, where do you fix that liability? And that could lead to frustration.

And again, in our episode with Gary Dewaal back in February, we talked about this, and this is what Gary had to say:

Gary: [00:09:54] What concerns me about the DeFi space is that bad facts make bad law. The regulators, they are going to get frustrated since they agree that source code makes bad captions. They are going to start looking for more theories of secondary liability.

Now you are right. Programmer where there is somebody clearly identified with a project, and there's someone clearly a promoter like the SEC brought a case against Zachary Coburn in connection with EtherDelta a couple of years ago, or for the EtherDelta platform, which is effectively a DeFi exchange, it's easy.

Then when the DeFi is constructed, I think it is not so easy. Then the question is who's going to be left holding the. I think you're going to have expensive theories of secondary liability. Now, as a lawyer, I would say I would take those cases on, because I don't think it's going to be so easy to get a court to agree with some of the theories of secondary liability, but that doesn't mean it's not going to be costly to defend those actions.

It doesn't mean it's not going to be costly to have to deal with your lawyers producing documents at deposition. It's definitely going to have a chilling effect and sure enough, there will be a court here and there that will hold for an expensive, you have liability. It's inevitable. And by the way, even if the regulators lose, let's just go back to Congress, or they'll go back to their state legislatures and say, "Hey, we need to plug this hole."

Eric: [00:11:07] Now, following up on this and circling back to what constitutes sufficient decentralization and the SECs acceptance of it. 2018, Bill Hinman, then the director of the Division of Corporate Finance within the SEC discussed how a digital asset that was offered as a security at one time could then subsequently become something other than a security.

And why is that relevant? Because a lot of time with these DAO projects, that initial action of forming the DAO of determining how it, it acts within the DAO structure could actually involve some element of centralization. So, at any rate, his point was if the network on which the token or the coin to function is sufficiently decentralized where purchasers would no longer reasonably expect a person or group to carry out the essential entrepreneurial efforts, those assets may not represent an investment contract. And he went on to say that when the efforts of a third party are no longer considered to be a key factor for determining the enterprises success, material asymmetries receipt, as a network becomes truly decentralized the ability to identify an issuer or a promoter to make the requisite disclosures become difficult. And less meaningful, so after Bill Hinman made this speech, there became a lot more focus on sufficient decentralization. And in fact, the Bill Hinman speech is still relied upon by the SEC even in their enforcement divisions, distributed ledger technology framework for digital assets, they cite the Hinman speech as primary example of the SECs guidance on the topic.

Yes, it's still very recent. And this gets into the discussion now on Bitconnect, which curiously a couple of days after Gary Gensler, commissioner Gensler, spoke before the House Subcommittee on Financial Services, and they published this complaint against the promoters of Bitconnect. Now in Bitconnect's case, there are a lot of bad acts.

There was fraud, but this isn't really about the bad acts. The issue here is how they're being approached and whether the decision by the SEC to bring this action three years after private actions and even state actions were initiated, whether they're trying to send a message and whether that message could have a chilling effect because the findings or the claims that were made against Bitconnect in this complaint go directly to this notion of liability.

And whether parties that are derivatively associated with the organization, in the case of promoters, they've certainly in the past promoters have been held liable for issuing unregistered securities. So that part isn't as strange as potentially the timing, and raising the question as to whether or not there is a broader issue going on that the SEC is trying to signal.

So as mentioned at the beginning of this podcast, Bitconnect was not incorporated, and thus all of its members were liable for the actions of the whole. And maybe that is the primary distinction here, as well as a warning for future DAOs. Bitconnect operated a Ponzi scheme that built the self-up as a lending program that was PTP and autonomous DeFi. Basically, by depositing Bitcoin, you would get Bitconnect back. And that raised I guess approximately 2 billion overtimes, or there was basically 2 billion at issue at one time, going through this or having gone through this lending program. And if you had this coin, you could transact with others on the network without any central organization being involved.

And you could basically tender this Bitcoin for the Bitconnect Coin and participate in this trading bot that they had created. Again, like a lot of DeFi protocols have today. Hopefully more legitimate though. This process could generate rewards of up to 40% a month. So those investors, who are they relying on? They were relying on a trading bot.

They had a referral program for promoters, they connected. So, these, basically the people who were involved in these promotions would have luxurious events for the promoters to convince them how much money they can make. And they paid them development funds. And top promoters that things like video, social media to market this lending program, prospective investors, and to show their accounts and how their interests were being calculated.

These promoters would provide referral links so that these prospective investors could tag them. And as a result, those promoters were compensated for bringing them in. I don't know if anybody's familiar with Amway, but Amway has this similar Ponzi structure, or they may not like me calling it a Ponzi structure, but basically that the higher you are up on the pyramid, the more money you make, because you're getting percentages of everybody who comes underneath you.

And of course, in Bitconnect, like in Amway. You had to pay a certain amount in to become a part of this chain. And, and this would often fund a lot of the flow, as well. But there was a lot of things that these promoters did that were sketchy and downright deceitful, and this pretty much lasted for a year.

And basically, when Texas state regulators got involved, the house of cards starting to fall. Most investors in the lending program lost everything. So even though this was a scheme, like a pyramid, if you think about a pyramid, what do you have at the top? You have the sort of that center, but pyramid structure does not necessarily mean that it's centralized because you know, the pyramid itself could be existing within a decentralized organization. And the whole pyramid structure would, could just be a way for basically facilitating the autonomous participants in the program.

So, as I said, Bitconnect, many ways it was operating a DeFi platform. They did have a lot of the components of a decentralized autonomous organization. Were they a decentralized autonomous organization in the purest sense? I'm not quite sure. They certainly operate- they had a lot of characteristics that were similar to a decentralized autonomous organization.

And I think if you're not using a strict definition, they probably fit the bill. Others might dispute that. So, what's interesting here is that the SEC brought action against the promoters for basically an unregistered securities offering. And the issue is that these promoters were participant in this decentralized, largely autonomous, organization. They weren't necessarily acting pursuant to any central management's directive, but yet they were still deemed to have engaged in unregistered securities offering of Bitconnect. When you think about this, what are the implications for other people participating in a decentralized autonomous organization?

And more specifically, I want to talk about developers. Because, once you remove a lot of the middlemen, once you handled your structure, market contracts, and a lot of the organization is going to be managed by developers. And these are the innovators. These are the builders. These are the creators.

These are the parties you don't want to have a chilling effect on. You want to encourage them to engage. And if a developer just contributes code to the DAO and takes no compensation for it, well I probably protected by the first amendment, because code is speech. Having said that if they get paid for it, which, hey developers do like to eat as well.

Now, all of a sudden, could they be exposing themselves to liability for making an unregistered securities offering? And you know, if you run that risk, why would you do that? And this doesn't necessarily only go to crypto. This really goes to any developer, working on a DAO, to the extent that they're taking capital for it, and maybe they're facilitating a DeFi platform or what have you. They could be held liable, arguably underneath this, you could extend that theory of liability to them.

And if they're not indemnified for that, they might have some concerns working for those. And it may cause these developers to go jurisdictions where they wouldn't have this risk and thus the country, which has succeeded in regulating these creators, will have hampered their own innovation.

This isn't just. This isn't esoteric, this is very real, and it could also apply to open-source projects going closed source, all these different things, all these different considerations.

Now, I don't know if it's mostly developers and they're just working, and they're the ones who are creating these smart contracts that act in this way.

Maybe they're the ones who are, who are going to be left, holding the bag. So that is a great concern. So, whether or not Bitconnect means that it's open season on developers. I don't think the SEC would say that it does. I think, with the timing of it and the potential signaling of it could the SEC be raising the specter that, "Hey, we'll get this one through and on the promoters for this decentralized organization."

And now maybe we'll start to expand those theories of secondary liability and hit some others. That would put, that would create further uncertainty in the market. I'm not really sure that it's ultimately the direction we ultimately want to go. So anyway, so that's a wrap for the episode today.

I hope you enjoyed it. If you have any comments, let me know. You can shoot me a text. You can DM me. You can show me something in LinkedIn. I'm at all of those places. I read them. I respond. So, if you liked the episode, please share it with your friends, your colleagues. Like it, and I look forward to your feedback.

Thanks so much, until next time.