

Mitigating Antitrust Risk In Decentralized Autonomous Orgs

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The proliferation of blockchain applications has enabled the creation of decentralized autonomous organizations, or DAOs.

DAOs offer the promise of delivering procompetitive benefits, such as increased efficiencies and lower costs, to members of these organizations, as well as to consumers. In the rush to market, however, it is important not to overlook antitrust risks.

Failing to ensure your DAO design does not restrain competition or enable collusive activities risks erasing any first-mover advantage and having the organization shut down as a whole.

Founders of DAOs and their in-house counsel need to take the proper precautions by auditing the DAO's design, implementing an antitrust policy and ensuring there is a way to address violations of that policy going forward because the decentralized nature of DAOs may otherwise make remediation of antitrust violations more challenging.

Democratization via DAOs

DAOs are lauded as a unique entity of the people, by the people, and for the people. Unlike traditional companies with governance structures run by executives and a board of directors, DAOs can take on what is heralded as a more egalitarian approach.^[1]

DAOs can be programmed to enable each member to vote on changes or new strategies to be implemented.^[2] Unlike traditional companies, with operations that are private, DAOs' governance operations can be made more transparent to members in an effort to keep all members engaged and informed.^[3]

What Is a DAO?

The term DAO, or decentralized autonomous organization,^[4] was coined by Ethereum founder Vitalik Buterin.^[5] Smart contracts are the building blocks for DAOs.^[6] A smart contract is a type of code that will seamlessly execute transactions on a blockchain network, as long as certain prerequisites are satisfied.^[7]

A DAO can be built on any cryptocurrency network with smart contract capabilities, such as Ethereum, Polkadot and Cardano.^[8] The funding of a DAO is frequently based on crowdfunding through issued tokens.^[9]

Types of DAOs

DAOs can come in many shapes and sizes, including venture DAOs, grant DAOs, collector DAOs, entertainment DAOs and social DAOs.^[10] DAOs can be designed in different ways that raise distinct legal risks.

DAOs issuing tokens, for example, may be subject to securities regulations. DAOs that include competitors can also raise antitrust concerns.

Depending on the design of a particular DAO, the founders might not even be aware that competitors are participating in the DAO and thus of the extent of antitrust risks raised by the design and decisions of the DAO.

Participation in a DAO could be open to anyone on an open network and on an anonymous basis. Conversely, DAOs can be designed on a private network and made accessible only to known participants given permission to join.

Venture DAOs

Venture DAOs, also known as investment DAOs, raise millions of dollars to satisfy the demand of owning a portfolio, which an average investor would not be able to accomplish on their own.^[11] Investment DAOs are typically transparent, inclusive and open to anyone.^[12]

In order to decide which sort of investments to fund, a quorum for a vote first needs to be established.^[13] A quorum refers to the minimum number of voting members who must be present at a meeting in order to conduct business in the name of the organization.^[14]

Having a lower quorum makes it easier to reach final consensus.^[15] However, the downside to a lower quorum is that a greater portion of the community ends up being removed from the decision-making process.^[16]

One way DAO members vote is by signing multisig messages with their private keys.^[17] These messages enable a transaction to be sent from the DAO contract.^[18]

Voting can also take place within a DAO via a tokenized DAO system such as Aragon.^[19] Typically, each member gets one voting token.^[20] DAO community members can engage, interact, and exchange ideas with one another through their member-only discord channels.^[21]

Grant DAOs

In grant DAOs, community members donate funds.^[22] From there, members decide how such funds should be allocated via governance proposals.^[23] One of the most successful grant DAOs is the Aave protocol.^[24] Within Aave, those with available funds can lend to, and those in need can borrow from, DAO members.^[25]

Collector DAOs

Collector DAOs are a type of DAO that buys and sells collections of NFTs.^[26] Collector DAOs purchase NFTs from specific collections or artists.^[27] Whale DAO is a collector DAO that contains a global catalog of community-owned collections of NFTs.^[28] Whale is governed by a community of \$WHALE token holders.^[29] \$WHALE token holders propose changes to the DAO and suggest which NFTs the DAO should buy and sell.^[30]

Entertainment DAOs

Entertainment DAOs provide their members with the opportunity to modify the story behind their favorite novel, movie, or TV show.^[31] The Bored Ape Yacht Club, an NFT project, has been developing such a blueprint to include in its own DAO, where members can vote on the creative decisions behind this project.^[32]

Jenkins the Valet, a Bored Ape Yacht Club NFT avatar who is the hero of the first-ever community-generated book, owns his own writing room, where members can vote on how this story unfolds and receive writing credits.^[33]

Social DAOs

Social DAOs are another type of DAO.^[34] Friends With Benefits, or FWB, unifies artists and cultural thinkers through member-only events.^[35] The community is governed via its FWB token.^[36] As with other tokenized DAOs, the price of the token correlates with the value of the community.^[37] Over FWB's lifespan, the cost of an FWB token has ranged from approximately \$5 to \$189.^[38]

Legal Risks of DAOs

Today, many regulators struggle to understand blockchain technology, how it can be used and designed, and its many forms, including DAOs. DAOs' lack of a consistently recognized legal status frequently defaults a DAO to a general partnership.

This can expose DAO members to unlimited liability.^[39] Only two states currently recognize DAOs as limited-liability legal entities: Wyoming and Vermont.^[40] Wyoming passed legislation in April 2021 that allows a DAO to be legally recognized as a limited liability company.^[41] Under Vermont law, a DAO can register as a Blockchain Based LLC and provide limited liability to its members.^[42]

This means that founders of DAOs may be individually liable for the legal exposure of their DAOs where they have not been formed as LLCs. Concerns such as tax evasion, money laundering, and the application of U.S. securities laws to DAO tokens are a number of well-documented legal issues that are regularly considered in connection with DAOs.^[43]

Addressing DAO Antitrust Risks at the Design Phase

DAOs have the potential to create procompetitive benefits, such as cost-saving efficiencies, that could not be accomplished without the formation of a DAO. However, in addition to ensuring compliance with other areas of law, DAO founders need to consider the antitrust implications of their particular DAO design, such as whether it will be open on a permissionless basis to anyone who may want to join.

The unsettled status of DAOs as a particular form of legal entity brings with it the risk that decisions made by DAO participants could be treated as joint conduct with the capacity to fix prices or otherwise restrain trade in violation of federal and state antitrust laws, which may even trigger criminal penalties, including jail time.

Under the antitrust laws, employees of the same company typically cannot conspire because there needs to be an agreement between two or more distinct economic actors to constitute a conspiracy.

However, courts have split as to what types of relationships constitute single-firm conduct, and DAOs may not have safeguards to prevent competitors from joining the same DAO, which could risk participants' being treated as distinct economic actors capable of conspiring or as prohibited interlocking directorates that enable competitors to coordinate competitive activity or exchange competitively sensitive information.

Decisions made by a DAO formally recognized as an LLC are more likely to be treated as single-firm conduct such that the DAO participants are legally incapable of conspiring with one another when making decisions for that particular DAO. However, corporate formalities alone will not suffice to protect a DAO that enables the coordination of competitive activity across competitors.

While the risk may be lower with respect to typical social or entertainment DAOs, new forms of DAOs are quickly emerging that may increasingly be used to determine prospective competitive conduct, such as what products to make or sell or how products will be priced.

Founders of such DAOs need to assess the risk that competitors may join or act through DAOs in a manner that may ultimately be treated by the antitrust agencies, in some circumstances, as independent actors with the capacity to conspire, fix prices, divide markets, restrain output, or otherwise engage in conduct that unreasonably restrains trade.

Founders that do not take precautions to ensure that conspiratorial agreements are not being formed through the DAO may find themselves to be subject to joint and several co-conspirator liability, which could leave the founder with the full financial exposure where anonymous conspirators acting through the DAO cannot be identified.

Even if voting or decisions made within a DAO are viewed as unilateral conduct on behalf of that organization, there are additional risks that competitively sensitive information can be shared among competitor participants and then used to restrain trade or engage in conspiratorial conduct outside that particular DAO.

Understanding and mitigating these risks at the implementation phase is essential in the DAO context because the decentralized and automated nature of such organizations may make it impossible to remediate potential antitrust violations in a cost-effective manner short of dismantling the organization as a whole.

If adequate safeguards are not implemented, DAOs could raise antitrust concerns that are ultimately challenged by the antitrust agencies as a conspiracy under section 1 of the Sherman Act, unfair competition under section 5 of the Federal Trade Commission Act, or an interlocking directorate under section 8 of the Clayton Act. Of course, even if a DAO is treated as a single firm, it could also still raise monopolization risks if it gains a dominant position even in a small, niche market.

Best Practices and Tips for Practitioners and Founders

Get started early.

DAOs are still novel and evolving. By getting into DAOs and blockchain early, founders will be able to gain a head start before their competitors.^[44]

While competitors are still struggling to navigate the convoluted legal landscape, these companies will already have their DAOs ready to go and be first to market. However, those that rush to market with an anticompetitive design or one that enables unlawful conspiracies to be formed through the DAO could find their first-mover advantage erased overnight if a flawed design is challenged by regulators, or worse, determined to provide an opportunity for criminal antitrust conspiracies to form.

DAOs should prepare a white paper that not only explains how their smart contracts work, but that also documents the DAO's antitrust safeguards and intended procompetitive benefits. Be sure to examine antitrust issues if the DAO is expected to set or affect prices in any market, no matter how new or small, or to discuss any competitively sensitive information.

Assess antitrust risks and consider risk-mitigating designs.

Depending on the type of DAO involved and its design, the antitrust risks could be minimal or high. Assess whether the DAO at issue raises potential antitrust concerns and whether there are ways to mitigate those risks through the design. For example, will management of the DAO require any level of participants to discuss competitively sensitive information or set prices?

If so, you should consider whether the DAO should be designed with more than one level of governance restricting access to competitively sensitive information to a select, vetted group of participants that does not include competitors. You should further assess whether permitting participants to join at any level on an anonymous basis could raise antitrust concerns if competitors are free to join.

If so, the DAO may want to restrict membership as a whole to those who are first vetted and approved. Membership policies, however, should be formalized and applied consistently to minimize risks of potential group boycott claims.

Implement an antitrust policy for the DAO that forfeits membership for violations.

All DAOs that raise antitrust risks should implement an antitrust policy from the start and ensure that mechanisms are put in place to address violations. For example, will your DAO have a private Discord server that would enable private communications among participants? Procedures should be put in place to monitor and report communications that violate the antitrust policy.

A mechanism should be implemented to review potentially problematic communications and to warn or expel as appropriate participants that violate the policy. Like membership policies, disciplinary policies should also be formalized and applied consistently to minimize exposure to group boycott claims.

Structure DAOs to avoid unlimited liability.

As noted above, DAO members typically do not receive the same protections against liability as do corporate shareholders because DAOs are not usually formed as a corporation or LLC. Consider structuring your DAO as an LLC to decrease the risk not only of individual liability of each member but also to increase the likelihood of being treated as a single entity under the antitrust laws.

Assess the risk of complying with different legal jurisdictions.

If your DAO is accessible from any jurisdiction, you will need to consider whether there are heightened risks in one or more jurisdictions. For example, some jurisdictions treat the exchange of competitively sensitive information more harshly than others. Consider whether the benefits of providing access to the DAO from all jurisdictions on a global basis are outweighed by the additional potential exposure or whether geographic limitations should be considered.

Ensure compliance with other laws.

Antitrust is just one area of law with which DAOs must comply. For example, DAOs issuing tokens must further ensure compliance with federal securities laws.^[45] Whether an anti-money laundering compliance program is required pursuant to Financial Industry Regulatory Authority Inc. rules should also be assessed.^[46]

Ensuring your DAO is compliant with all applicable legal regulations from the start ultimately may prove to be a competitive advantage because those that rush to market without doing so risk being temporarily enjoined, having their investments drained, or being taken off the market permanently.

Conclusion

DAOs can have many procompetitive benefits; can create new products and opportunities; and can enable businesses to operate more efficiently via smart contracts, voting, and decentralization. Nonetheless, DAOs can raise a number of legal challenges from the start that cannot be ignored.

With respect to antitrust law, founders of DAOs and their counsel need to understand the competitive contours of their market and potential antitrust risks raised by their organization and design before exposing the DAO and its participants to potential civil or criminal exposure under the antitrust laws.

Given the novelty of DAOs, founders and their counsel also need to monitor the evolving legal landscape and public statements made by regulators as they become more familiar with DAOs. As DAOs become better understood by regulators, founders may need to consider additional areas of law as well, making it essential to have access to an interdisciplinary legal team.

Despite these legal challenges, founders should not be discouraged from creating these exciting new entities that have the potential to enhance competition by creating new efficiencies and synergies made possible by DAOs.

DAOs that invest early will gain a first-mover advantage they may be able to build upon for future success, provided they take proper legal precautions.

The decentralized nature of DAOs and the distribution of control across many members, however, make it imperative for DAOs to address antitrust risks early on. The key is for DAOs to be done right by ensuring that legal implications are taken into account and compliance risks are mitigated from the outset.

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