

## BLOCKCHAIN

## Emerging Issues in Decentralized Governance and the Lessons of Corporate Governance

**By Kevin S. Schwartz, David M. Adlerstein, David E. Kirk, and I. Andrew Mun**

While recent gyrations in cryptoasset markets have focused attention on the future contours of stablecoins, market-making, and impending regulation, another feature of the blockchain landscape is also confronting noteworthy challenges. Specifically, a new breed of business organization has emerged that is defined by its rejection of the centralized, traditional governance structures at the heart of our modern corporations. These decentralized blockchain-based organizations are conducting a substantial, growing volume of business activity, and many are encountering a variety of governance challenges.

Some of these challenges are novel, but many others strikingly resemble those that corporations have confronted for decades. We believe that governance design for these organizations should heed some of the hard-fought lessons that have helped to form the pillars of modern corporate governance.

Blockchain networks that allow the limitless programming of computer code (such as Ethereum) enable software developers to create business applications that run without the need for further human administration. A prominent example is Uniswap: a decentralized application that enables the trading of cryptocurrencies through an automated market-making function, with more than \$1 trillion in trading volume to date.

Decentralized trading exchanges such as Uniswap are but one flavor of business activity using

decentralized blockchain protocols. Among other examples, there are popular decentralized applications for collateralized lending and even more sophisticated financial applications.

Very often, these protocols are controlled not by a central managerial authority or corporate organizational documents, but rather by a diffuse group that governs the protocol by referendum, in accordance with parameters built into the computer code. Blockchain applications governed in this manner are known as Decentralized Autonomous Organizations (DAOs). Typically (as in the case of Uniswap), the right to vote in a DAO's governance is based on ownership of a cryptoasset known as a "governance token," akin to voting rights in a corporation.

There are thousands of DAOs of varying design, from simple single-purpose organizations, to elaborate formats melding governance by DAO tokenholders with traditional corporate forms. DAOs collectively hold billions of dollars of assets and can conduct business at significant scale, for instance, by pooling participants' capital, by transacting or investing in both cryptoassets and other assets, and by interacting with other blockchain protocols and DAOs, all without centralized management or the involvement of traditional legal entities.

For all the intriguing potential of the DAO organizational form, it is worth remembering that traditional corporations benefit from a modern system of corporate governance that is the product of carefully honed statutes, sophisticated jurisprudence, and battle-tested practice, which together offer consistency and predictability that redound to overall social benefit. Conversely, nascent DAO governance models vary in the extreme and—although often very thoughtful in design—frequently pose

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practical challenges that already have been confronted in the domain of corporate governance. For example:

- DAOs' tokenholders and developers do not owe, or have the benefit of, fiduciary duties, and conflicts of interest may abound without adequate safeguards;
- Some DAOs require frequent technical decisionmaking by non-experts, with attendant inefficiency and risk of low voter participation;
- Although there are nascent efforts to recognize DAOs as legal persons (for example, Wyoming has enacted a DAO statute), there is a risk that some DAOs could be found to have the legal status of general partnerships, exposing founders and tokenholders to unlimited liability;
- Some DAOs form traditional business entities to conduct important operations (for example, banking, hiring employees, retaining service providers, etc.), but this practice poses many legal and regulatory questions;
- Many DAOs enable unchecked voting-related activity, wolfpack-like activity, solicitation activity, and undisclosed voting arrangements;
- DAOs often have unclear or suboptimal dispute resolution mechanisms; and
- Computer code may be susceptible to design flaws, cyberattacks, and exploitation, and the inherently decentralized governance in DAOs may impede adequately nimble responses to a security crisis.

If DAOs are to be deployed on a large scale as blockchain technology expands to important areas of the economy, it will be critical to reckon with challenges like these through the development of appropriately tailored code-based rules, best practices, and, where applicable, laws.

Select design elements from the carefully constructed edifice of modern corporate governance may provide at least a partial blueprint for DAO governance. For example, consider the concept of a proxy season: Although public corporations occasionally hold special meetings, they have a single proxy season and rules prescribing reasonable notice

procedures and ownership thresholds for proposing business at a meeting.

A corresponding best practice for a DAO—in lieu of a relentless dribble of referenda—could be to hold non-emergency referenda only at reasonable periodic intervals following adequate notice and based on reasonable ownership thresholds. More broadly, aspects of the New Paradigm for Corporate Governance, designed to foster long-term value creation for all stakeholders, may also provide valuable guidance to DAOs to address the interests of tokenholders and broader stakeholders as well. (Reciprocally, blockchain technology may eventually yield innovations that could benefit traditional corporations' governance, such as by streamlining some of the mechanisms of the US proxy system.)

We do not contend that all features of modern corporate governance bear precise applications in the DAO context. But good governance over business organizations is a vital social good, and the dynamics that produced these features have analogues that merit serious consideration in seeking to optimize DAO governance. Much like our modern corporate governance best practices, DAO governance practices warrant ongoing examination and fine-tuning in pursuit of sustainable long-term value for tokenholders and other stakeholders alike.

A final thought is worth underscoring. Today, DAOs look innovative and novel. But from the perspective of business history, they are just the latest example of dynamic market activity. The fundamental purpose of enabling corporate law statutes like Delaware's and of the business judgment rule is to ensure that business leaders can innovate and can take risks without fear of undue liability or inhibition.

The US corporate law model has facilitated creative business development in cutting-edge industries for generations, while providing credible and important protection to investors, creditors, and other stakeholders. That model can be adapted by DAOs in a manner that allows their economic potential to flourish but that answers important questions about their value to their investors, stakeholders, and society.

## CRYPTOCURRENCY

# The Edge of Tomorrow: A Review of the Past, Present, and Future of Crypto Enforcement

By **Christopher Bosch and Gabriel Khoury**

Since the enigmatic Satoshi Nakamoto<sup>1</sup> penned the landmark whitepaper entitled “Bitcoin: A Peer-to-Peer Electronic Cash System”<sup>2</sup> in October 2008, digital assets have taken the world by storm and ingrained themselves in the fabric of industry, culture, and law. Regulatory enforcement in this space has progressed in roughly three phases, with some overlap and exceptions.

From about 2013 to 2018, regulators contemplated the ramifications of digital assets and issued guidance while also pursuing a handful of enforcement actions. The period from 2018 to the present has been marked by increased direct enforcement action by regulators operating under existing law. In mid-2022, Congress threw its hat in the ring, introducing a comprehensive bipartisan bill aimed at establishing a coherent regulatory framework for the future. This article journeys through crypto enforcement’s contemplative past and dynamic present, concluding with a look toward what the future may hold.

### The Past: Study and Guidance

The period from about 2013 to 2018 can be characterized as one of careful study of the industry by regulators, who issued reports and public commentary as a means of helping early adopters understand legal risks and comply with existing laws.

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These efforts established a regulatory baseline and continue to serve as important guideposts for the industry. Some essential resources from three of the most relevant regulators in this space include the following:

- **Securities and Exchange Commission (SEC):** On July 25, 2017, the SEC released the Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (DAO Report) applying the *Howey Test*<sup>3</sup> to the operation of a specific decentralized autonomous organization.<sup>4</sup> On June 14, 2018, the SEC’s then-Director of the Division of Corporation Finance, William Hinman, issued public remarks addressing the circumstances under which a digital asset initially offered as a security could, over time, become a non-security.<sup>5</sup> On April 3, 2019, the SEC released its Framework for “Investment Contract” Analysis of Digital Assets, offering an in-depth look into what characteristics the SEC considers especially relevant when applying the *Howey Test* to digital assets.<sup>6</sup>
- **Commodity Futures Trading Commission (CFTC):** On October 17, 2017, the CFTC published its *Primer on Virtual Currencies* setting forth the operational, speculative, cybersecurity, and fraud/manipulation risks posed by virtual currencies, as well as the CFTC’s perceived oversight role.<sup>7</sup> On November 27, 2018, the agency released its *Primer on Smart Contracts*, which discussed the operation of, and risks associated with, smart contracts, as well as the intersection of smart contracts and federal commodity law.<sup>8</sup>

- **Department of Treasury:** Recently, Treasury published a study on the facilitation of money laundering and terror finance through the art trade, including a focus on digital non-fungible tokens (NFTs).<sup>9</sup> The Treasury has also issued guidance through its bureaus and offices, including the following:
  - — **Financial Crimes Enforcement Network (FinCEN):** FinCEN released some of the earliest crypto guidance with its March 18, 2013 publication addressing the application of FinCEN’s regulations to virtual currencies with regard to reporting suspicious activity, sanctions evasion, and other illicit financing purposes.<sup>10</sup> On May 9, 2019, FinCEN issued an advisory regarding convertible virtual currency that identified thirty red flags industry players should look for.<sup>11</sup>
  - — **Internal Revenue Service (IRS):** In 2014, the IRS issued guidance explaining how existing general tax principles apply to transactions using virtual currency.<sup>12</sup> The IRS also maintains an online list of “Frequently Asked Questions on Virtual Currency Transactions” for individuals who hold cryptocurrency as a capital asset.<sup>13</sup>
  - — **Office of Foreign Assets Control (OFAC):** In October 2021, OFAC published a report regarding virtual currencies addressing who must comply with OFAC regulations, OFAC requirements and procedures, consequences for non-compliance with regulations, the strict liability standard of sanctions violations, and best practices.<sup>14</sup>

## The Present: Increased Enforcement

The year 2018 represents an inflection point of sorts in terms of regulators transitioning from issuing guidance to embarking on a sustained enforcement program. The SEC brought 11 enforcement actions

between 2013 and 2017. That number increased seven-fold over the next four years during which time the SEC brought 77 enforcement actions, and 18 in 2021 alone.<sup>15</sup> The CFTC has filed more than 50 enforcement actions related to digital assets since 2015, with almost half of those (23) coming within the last fiscal year.<sup>16</sup>

As set forth below, in the first half of 2022, the government not only continued to pursue enforcement actions, but also sought to bring about structural changes to the existing regulatory landscape designed to increase its oversight.

### January

- The SEC proposed a rule amending, and significantly broadening, a rule that defined “exchange” under SEC rules.<sup>17</sup> This definition could reach cryptocurrency exchanges, which might require their operators to register with the SEC. The SEC reopened the comment period for the proposed rule in May 2022, and it closed in June 2022. There is no indication of when or whether the rule will be implemented.
- The SEC charged an Australian citizen and two companies he founded with making materially false and misleading statements in connection with an unregistered offer and sale of digital asset securities.<sup>18</sup>

### February

- The Department of Justice (DOJ) announced its first Director of its newly-minted National Cryptocurrency Enforcement Team, Eun Young Choi, a former Assistant United States Attorney in the Southern District of New York known for prosecuting cybercrime cases, including the case against the founder of the infamous Silk Road dark web marketplace.<sup>19</sup>
- The FBI launched a new task force dubbed the Virtual Asset Exploitation Unit, a “specialized team of cryptocurrency experts dedicated to providing analysis, support, and training across

the FBI, as well as innovating its cryptocurrency tools to stay ahead of future threats.”<sup>20</sup>

- The SEC settled charges against a cryptocurrency lending platform for failing to register its retail crypto lending product and operating as an unregistered investment company.<sup>21</sup>

### March

- President Biden signed an Executive Order ordering a whole-of-government approach to cryptocurrency regulation.<sup>22</sup> The Order offers a strong endorsement of the potential of digital assets and the need for the United States to play a leading role in shaping the design of this ecosystem.
- The SEC announced its examination priorities for the fiscal year 2022, listing “Emerging Technologies and Crypto-Assets” as one of five “Significant Focus Areas.” Specifically, the SEC is targeting robo-advisers, digital asset fractionalization, and other crypto-custody arrangement practices.<sup>23</sup>
- The CFTC charged four individuals with fraud for operating an alleged bitcoin Ponzi scheme.<sup>24</sup>
- The SEC charged two defendants with defrauding thousands of retail investors out of more than \$124 million through unregistered securities offerings involving a digital token created by the defendants.<sup>25</sup>
- The DOJ charged two individuals with conspiracy to commit wire fraud and conspiracy to commit money laundering in connection with a million-dollar NFT fraud.<sup>26</sup>

### April

- The SEC brought fraud charges against a company, its founders, and two other entities in connection with the unregistered offerings and fraudulent sales of investment plans called mining packages to thousands of investors.<sup>27</sup>
- The SEC charged two entities and their co-founders with conducting a fraudulent unregistered securities offering.<sup>28</sup>

- The SEC charged several individuals for their roles in raising over \$10 million through two fraudulent and unregistered digital asset securities offerings.<sup>29</sup>
- SEC Chair Gary Gensler outlined the SEC’s enforcement priorities as they relate to blockchain and cryptocurrencies addressing the SEC’s approach to cryptocurrency trading platforms, stablecoins, and crypto tokens.<sup>30</sup>
- OFAC sanctioned the world’s largest and most prominent darknet market and a virtual currency exchange operating out of Moscow and St. Petersburg.<sup>31</sup>
- The Texas State Securities Board and Alabama Securities Commission issued cease-and-desist orders against individuals selling NFTs to fund the creation of metaverse casinos asserting the activities constituted unregistered securities because benefits to NFT holders included a pro-rata share of casino profits.<sup>32</sup>
- The Manhattan District Attorney indicted a Bitcoin ATM operator for failing to collect and maintain customer identifying information and operating without a money transmission license.<sup>33</sup>

### May

- The SEC nearly doubled the size of its Crypto Assets and Cyber Unit.<sup>34</sup> The Unit is responsible for protecting crypto investors.
- California Governor Gavin Newsom signed a “blockchain executive order to spur responsible Web3 innovation, grow jobs, and protect consumers.”<sup>35</sup>
- CFTC Chairman Rostin Behnam stated that he would “ensure that the CFTC continues to prioritize using [its] existing authority to root out fraud and manipulation” in crypto markets and would “continue adding additional resources to this area to meet the increasing prevalence of digital asset fraud.”<sup>36</sup>
- The CFTC charged several individuals for fraudulently soliciting at least \$44 million for participation interests in a so-called “income

fund” investing in digital assets and other instruments.<sup>37</sup>

- OFAC announced its first sanction of a virtual currency mixing service asserting that the Democratic People’s Republic of Korea used the service to process over \$20.5 million in proceeds from a virtual currency heist.<sup>38</sup> A mixer, or tumbler, is a service that takes in streams of cryptocurrency from various sources, mixes them, and returns a bundle of mixed cryptocurrencies to the user, presenting a potential money laundering risk.

## June

- The United States Attorney for the Southern District of New York unsealed an indictment charging a former NFT marketplace employee with wire fraud and money laundering in connection with a scheme to use confidential insider information to trade NFTs for personal gain.<sup>39</sup>
- FinCEN announced a proposal to implement a no-action letter process, which would allow crypto companies to inquire of the regulator “whether and how anti-money laundering or countering the financing of terrorism laws and regulations apply to specific conduct.”<sup>40</sup> The comment period for the proposed rule was set to close on August 5, 2022, and there is no indication when the rule may be implemented.

## The Future: *Time for Legislation?*

All signs point toward continued focus by regulators on this space. A critical question is whether enforcement will continue under existing laws or if Congress will establish a new legal framework. The industry caught a glimpse of what such a framework might look like on June 7, 2022, when Senators Kirsten Gillibrand (D-NY) and Cynthia Lummis (R-WY) introduced S. 4356, the Responsible Financial Innovation Act (RFIA), a bill that represents the most comprehensive federal crypto legislation to date.<sup>41</sup>

The 69-page bill aims to “create a complete regulatory framework for digital assets that encourages responsible financial innovation, flexibility, transparency, and robust consumer protections while integrating digital assets into existing law.”<sup>42</sup>

One aspect of the wide ranging-bill that has garnered particular attention is its assignment to the CFTC of “exclusive jurisdiction over any agreement, contract, or transaction involving a contract of sale of a digital asset in interstate commerce, including ancillary assets . . . .”<sup>43</sup> The bill defines “digital asset” under the Council of Economic Advisors (CEA) as a natively electronic asset that confers economic, proprietary, or access rights or powers and is recorded using cryptographically secured distributed ledger technology, or any similar analogue, including virtual currency and ancillary assets, subject to certain exceptions discussed below.

It defines an “ancillary asset” as “an intangible, fungible asset that is offered, sold, or otherwise provided to a person in connection with the purchase and sale of a security through an arrangement or scheme that constitutes an investment contract, as that term is used in Section 2(a)(1) of the Securities Act of 1933<sup>44</sup>” subject to certain exceptions discussed below.<sup>45</sup> This conferment of jurisdiction, some may argue, tips the balance of enforcement authority from the SEC to the CFTC.

While this language might appear to confer the CFTC with sweeping jurisdiction over digital assets, there are several important caveats that temper this conclusion:

*First*, the definitions of “digital asset” and “ancillary asset” both exclude assets that provide the holder with certain “rights in a business entity,” including “a profit or revenue share in [an] entity derived solely from the entrepreneurial or managerial efforts of others.” This verbiage seems borrowed from the fourth element of the *Howey* Test, which considers whether an individual is led to expect profits solely<sup>46</sup> from the entrepreneurial or managerial efforts of others. Whereas (i) the expectation of profits derived from the efforts of others is necessary (but not sufficient) to deem a digital asset a security subject to SEC

jurisdiction pursuant to the *Howey* Test, and (ii) the presence of such profits removes the asset from CFTC jurisdiction under the RFIA, it appears that the RFIA may *prohibit* the CFTC from exercising jurisdiction over assets that would be deemed securities under the *Howey* Test.

*Second*, the investment contract pursuant to which an ancillary asset subject to CFTC jurisdiction is issued would be separately deemed a security subject to the jurisdiction of the SEC.<sup>47</sup> As such, it is conceivable that the launch of a blockchain-based project could implicate the jurisdiction of both the SEC and CFTC simultaneously.

*Third*, the designation of an ancillary asset is a presumption that can be rebutted in federal court, where the court may issue an order that there is no substantial basis for finding the asset is a commodity and not a security.

In addition to this focus on enforcement jurisdiction, the RFIA would revamp the existing regulatory regime by effecting the following changes, among many others:

- Requiring state regulators to ensure uniform treatment of digital assets under state money transmitter laws;
- Establishing a framework for regulating stablecoins;
- Establishing requirements and disclosures for lending and rehypothecation activities relating to digital assets;
- Establishing customer fund segregation requirements;
- Addressing the tax implications of cryptocurrency transactions;
- Requiring studies on digital asset energy consumption; and
- Addressing the national security implications of cryptocurrency.

The ambitious bill faces an uncertain future with November elections around the corner as it has been referred to committee in the Senate, has no analogue in the House, and may or may not gain President Biden's favor. Nonetheless, the bill suggests that a new statutory framework for crypto enforcement

aimed at bringing clarity and cohesion to this complex regulatory environment may be on the horizon.

## Conclusion

In the first five or so years following the spread of digital assets into the marketplace, regulators assumed a largely educational role with regard to digital assets, studying them and promulgating guidance regarding application of existing laws to digital assets and their perceived scope of authority in enforcing same. More recently, we have seen regulators transition from edification to increased direct enforcement.

This year in particular has been marked by a flurry of pronouncements, the clear marshaling of regulatory resources, active enforcement, and sweeping draft legislation, all of which collectively demonstrate that the government is growing increasingly comfortable exercising enforcement authority and Congress has heard the pleas to fill regulatory gaps through legislation.

Industry participants can expect enforcement activity to continue ramping up consistent with past guidance and current enforcement trends unless and until legislation like the Responsible Financial Innovation Act is enacted, which has the potential to transform the regulatory regime that has persisted to date and help crypto industry participants better understand their legal obligations.

## Notes

1. Satoshi Nakamoto is the presumed pseudonymous name utilized by the person or persons credited with devising Bitcoin and its technical implementation. While several people have been identified as possibly being Nakamoto, the identity of Bitcoin's progenitor(s) has remained unconfirmed for nearly fourteen years. See Paul Vigna, "Who Is Bitcoin Creator Satoshi Nakamoto? What We Know—and Don't Know," *WSJ.com* (Dec. 7, 2021), available at <https://www.wsj.com/articles/who-is-bitcoin-creator-satoshi-nakamoto-what-we-know-and-dont-know-11638020231>. It is estimated that Nakamoto owns approximately one million Bitcoin

- mined in its first year that have never been moved. Id. As of June 2022, these holdings are worth approximately \$21 billion.
2. Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System 1 (2008), <https://bitcoin.org/bitcoin.pdf>.
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  40. Al Barbarino, “FinCEN No-Action Plan May Spur Crypto Innovation, in Theory,” *Law360* (June 15, 2022, 6:00 PM)

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42. Press Release, Kristen Gillibrand: U.S. Sen. for N.Y., Lummis, Gillibrand Introduce Landmark Legislation to Create Regulatory Framework for Digital Assets (June 7, 2022), <https://www.gillibrand.senate.gov/news/press/release/-lummis-gillibrand-introduce-landmark-legislation-to-create-regulatory-framework-for-digital-assets>.
43. § 403(F). If a digital asset is issued pursuant to a contract of sale in interstate commerce that does not constitute an investment contract, the CFTC would retain exclusive jurisdiction over that contract, but it is unclear from the text of the statute whether the CFTC would necessarily retain jurisdiction over the asset itself. § 403(F)(i)(I).
44. 15 U.S.C. § 1377b(a)(1).

45. § 41(a)(1)(A).

46. While the Supreme Court in *Howey* used the term “solely,” some Circuit Courts of Appeal have since applied a more flexible standard to prevent promoters from avoiding securities regulation by offering investors trivial participation rights in investment contracts, and the Supreme Court is yet to comment on how far the *Howey* test may depart from the term’s literal conception. See Ori Oren, “ICO’s, DAO’s, and the SEC: A Partnership Solution,” 2018 *Colum. Bus. L. Rev.* 617, 624 (2018). It is unclear whether the term “solely” in the RFIA is intended to be read literally or more expansively. A bill summary released by Senators Lummis and Gillibrand states that the bill “codif[ies] existing precedent under the *Howey* test” but does not otherwise specifically address this issue. See Lummis-Gillibrand Responsible Financial Innovation Act: Section-by-Section Overview, available at <https://www.gillibrand.senate.gov/imo/media/doc/Lummis-Gillibrand%20Section-by-Section%20%5bFinal%5d.pdf> (last visited June 21, 2022).
47. § 403(F).