



**The Journal of Robotics,
Artificial Intelligence & Law**

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Recent Enforcement Proceedings Against Decentralized Autonomous Organizations and Liability Risk

Ali Dhanani and Brian J. Hausman*

In this article, the authors explain that the Commodity Futures Trading Commission's recent enforcement action against a decentralized autonomous organization (DAO) has generated both procedural and substantive questions for DAOs. They conclude that each DAO may weigh the advantages and disadvantages in determining whether to register as a limited liability company and within which state.

The recent enforcement action against Ooki DAO sent a clear message that activities in the United States by decentralized autonomous organizations, or “DAOs,” will be subject to stricter scrutiny. As background, a DAO is an organizational structure with an objective that is maintained on a blockchain or distributed ledger. The objective can be any wide-ranging common goal shared by members of the DAO, including donating to charities, collecting art, operating as an investment fund, etc.¹

DAOs are unlike most traditional organizational structures in that there is no hierarchy among members of a DAO; operational control is spread among its members. Any one member can submit a proposal for the DAO to perform a certain action, wherein the proposal is voted on by the members of the DAO and action occurs if the proposal is sufficiently affirmed.

The concept of a DAO first emerged in the 1990s to describe multi-agent systems in an internet-of-things (IoT) environment,² but the first functional DAO, known as “The DAO,” was created in 2016 to function as a collective venture capital fund. After fundraising, The DAO was hacked, and the attack on The DAO brought widespread attention to decentralized autonomous organizations as a potential new form of organizational structure.

The legal environment surrounding DAOs remains uncertain with respect to certain regulation and treatment of the activities of

a DAO. It is not uncommon for a DAO to pool together large sums of money from its members to fund future operations through a token sale.

In addition to each DAO's operating software being publicly available to anyone, there is potential for an attempted hack or manipulation by a bad actor to steal the collected funds.

Regulatory agencies and legislators desire to protect consumers from the activities of a DAO through anti-money laundering policies, know-your-customer procedures, securities and commodities regulations, etc. Because DAOs are relatively new compared to more traditional organizational structures, standard legislation and regulation for corporations or limited liability companies may not adequately protect key interests of stakeholders. Policymakers must determine how best to implement and apply regulations and legislation to these DAOs in view of existing public policy and legislation.

The CFTC Enforcement Action Against Ooki DAO

Overview

On September 22, 2022, the Commodity Futures Trading Commission (CFTC) issued an order simultaneously filing and settling charges against bZeroX, LLC (bZeroX), a company that had been operating as a predecessor to Ooki DAO, and its co-founders.³ The co-founders previously transferred operations of bZeroX to Ooki DAO to attempt to become "enforcement proof." Both bZeroX and Ooki DAO are alleged to have been and continue to operate, respectively, a blockchain-based software protocol that accepts orders for and facilitates margined and leveraged retail commodity transactions (i.e., functioning similarly to a trading platform).

This protocol (the bZx Protocol, then later renamed the Ooki Protocol) permitted users to contribute margin to open leveraged positions whose ultimate value was determined by the price difference between two digital assets from the time the position was established to the time it was closed. The protocol purported to offer users the ability to engage in these transactions in a decentralized environment—that is, without third-party intermediaries taking custody of user assets. The protocol is a collection of smart

contracts on the Ethereum blockchain capable of facilitating the aforementioned transactions without intermediaries.

Operations were not conducted through a registered entity with the CFTC, and both bZeroX and Ooki DAO failed to implement practices for customer protection. The issued order accepted the co-founders' settlement offer related to the actions of the predecessor company, but the CFTC concurrently filed an enforcement action against Ooki DAO as Ooki DAO continues to operate.⁴ The enforcement action against Ooki DAO was filed in the U.S. District Court for the Northern District of California for violations of the Commodity Exchange Act (CEA) and the CFTC's regulations.

The CFTC asserts that the Ooki DAO is an unincorporated association within the issued order settled by the co-founders of bZeroX. The CFTC acknowledges that the Ooki DAO does not define its membership but reasons that an individual becomes a member of the Ooki DAO unincorporated association by voluntarily participating in the group formed to promote the common objective of governing the Ooki Protocol by voting on a proposal.⁵ The complaint against Ooki DAO incorporates these definitions and settled findings from the issued order against bZeroX.⁶

Specifically, the complaint asserts one count for engaging in unlawful off-exchange leveraged and margined retail commodity transactions in violation of 7 U.S.C. § 6(a), one count for engaging in activities that can only lawfully be performed by a registered futures commission merchant (FCM) in violation of 7 U.S.C. § 6(d), and one count for failure to implement a customer information program, know-your customer procedures, and anti-money laundering procedures in violation of 17 C.F.R. § 42.2.

The CFTC requests relief in the form of a permanent injunction prohibiting Ooki DAO from continuing to engage in conduct in violation of the CEA and the CFTC's regulations, monetary penalties, and other ancillary relief, including trading and registration bans, restitution, judgment interest, and any other relief the court finds necessary and appropriate.

Dissenting Statement by Commissioner Summer K. Mersinger

Commissioner Mersinger issued a dissenting statement in view of the complaint against Ooki DAO and the issued order settling

charges with the co-founders of bZeroX. The commissioner provides four separate points related to defining the Ooki DAO as an unincorporated association and holding its members liable.

1. There is a lack of legal authority;
2. Disincentive to good governance in the crypto environment;
3. Regulation by enforcement; and
4. Disregard for an established theory of liability authorized by Congress.

With respect to the first point, the CFTC explains how the Ooki DAO meets the federal definition of an unincorporated association, then solely relies on three cases decided under state law to determine that the individual member is personally liable for the debts of the unincorporated association. The commissioner questions the CFTC's action based on a legal theory derived from state common law, where Congress did not convey such power to the CFTC. Congress explicitly provides three legal theories within the CEA that the CFTC can rely on for charging an individual for violating the CEA and the CFTC's regulations:

- Principal-agent liability;
- Aiding-and-abetting liability; and
- Control person liability.

Skipping to the fourth point, the CFTC could have found the co-founders liable for the actions of Ooki DAO based on aiding-and-abetting liability. The CFTC could have attempted to show that the CEA was violated by the Ooki DAO, that the co-founders knew of the Ooki DAO's actions constituting the violation, and that the co-founders intentionally acted in furtherance of the Ooki DAO's actions. This would appear to be an easier, and more established, route to take rather than to apply state common law theory.

Referring back to the remaining two points, the commissioner argues that the CFTC's definition of the Ooki DAO unincorporated association as "comprising those who vote their Ooki tokens" undermines public interest in that environment. Such a definition, if successfully enforced, would dissuade any token holder of a DAO from actively participating in the DAO.

Further, the CFTC knows this action will have effects on public policy regarding future treatment of DAOs. There was no public notice or comment period as is typical in informal rulemaking

procedures by agencies. A public notice-and-comment rulemaking proceeding would provide notice to the public about the way in which the Commission is currently thinking about these important questions and would allow for adoption of rules addressing the novel and difficult public policy questions that are raised here, such as (1) who is a member of a DAO that is an unincorporated association, and (2) within the bounds of the statutory authority granted by Congress in the CEA, who will the Commission hold personally liable for a DAO's violations of the CEA and CFTC rules, and under what circumstances?

Instead, the CFTC has brought this and other enforcement actions in the absence of clear rulemaking in areas related to DAOs or other digital assets.

Motion for Alternative Service

In an unprecedented manner, the U.S. District Court for the Northern District of California has accepted the CFTC's motion for alternative service for this action. On the day of filing, the CFTC sent a copy of the summons and complaint through the Ooki DAO's Help Chat Bot and posted copies in the Ooki DAO's online forum. By granting this motion, Ooki DAO had until October 13, 2022, back-dated 21 days from the CFTC's actions, to submit a responsive pleading or risk a default judgment in favor of the CFTC. Since then, multiple third parties have joined the case and have submitted briefs protesting the CFTC's alternative means of service.⁷ The judge has stated that he would treat the amicus filings as motions to reconsider his order approving alternative means of service for the DAO. The CFTC had to respond to the amicus arguments by November 7, 2022, and a hearing was scheduled to discuss the dispute on December 7, 2022.⁸

The Federal Rules of Civil Procedure (FRCP) set forth standards, which must be followed by the present court, regarding methods of serving a defendant that are sufficient for due process. FRCP Rule 4 provides standards for serving individuals (Rule 4(e)-(f)) and an unincorporated association (Rule 4(h)), both of which allow the court to follow state law for serving a summons. California does not expressly permit using online means for serving a defendant, but California Code of Civil Procedure § 413.30 provides that if a summons cannot be served using traditional

methods, the court may order service in any alternative manner reasonably likely to give notice to the defendant.⁹ Due process requires that “the method of service crafted by the district court must be ‘reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections.’”¹⁰ A number of federal courts in California have found that “service by email is reasonably calculated to provide actual notice.”¹¹

However, would sending a copy of the summons and complaint through the Ooki DAO’s Help Chat Bot and posting copies in the Ooki DAO’s online forum satisfy Ca. Civ. Proc. Code § 413.30 in the present case? Typical chat bots are programmed to simulate natural human dialogue by providing automated responses based on specific input without human operation on the back end. It seems unlikely that uploading a copy of the summons and complaint to the Ooki DAO’s Help Chat Bot would even be processed by the chat bot. Often, chat bots will ask for additional user input if the initial input (here the uploaded copy of documents) cannot be processed under one of its pre-programmed responses.

Further, chat bots are designed for operation without another human on the back end. As the complaint alleges that individual Ooki token holders are liable for these violations, how would each one of them be apprised of the enforcement action? Would an automatic response generated by a chat bot be enough to prove notice of the summons and complaint?

Posting copies to the Ooki DAO’s online forum seems to better satisfy FRCP Rule 4 in the present action. The motion for alternative service explained that “by choosing to organize itself as a DAO, the Ooki DAO has structured its business in a way that has erected significant obstacles to traditional service of process.” The motion argued that discussions of the lawsuit and “at least 112 views of the CFTC’s post in the Online Forum regarding the action” are enough to indicate that the DAO was properly served.¹²

For the present and future cases, however, how would the complainant prove that certain individuals participating in the DAO viewed the copy of the summons and complaint on the online forum? While the complainant may be able to establish imputed notice to a DAO in a subsequent case, can the complainant successfully hold an individual liable for the actions of that DAO who stopped participating in the online forum (i.e., such that the individual did not see the summons and complaint) but had previously

participated in the DAO by voting on a governance proposal? Affirmation of this statement seems to suggest a violation of that individual's due process.

Examples of Setting Up a DAO as a Legal Entity

Formation

One exemplary formation of a DAO is to consider registering as a type of limited liability company (LLC). There are two states that have enacted legislation that expressly recognizes a DAO as a type of LLC: Wyoming and Tennessee.

Vermont may also provide protection for a DAO, but the state does not expressly call out “decentralized autonomous organizations.” Vermont legislation applies to companies that “utilize blockchain technology for a material portion of its business activities.” Those companies would register as a blockchain-based limited liability company (BLLC) and are subject to the provisions of Vermont's standard LLC law. However, Vermont does not provide sufficient description in its legislation associated with DAOs in comparison to the other two states.

Wyoming is the first state in the U.S. to legally recognize a DAO,¹³ and Tennessee is the second after passing Tenn. Code Ann 48-250-101 on April 20, 2022. The Tennessee statute significantly borrows from the requirements set forth by Wyoming, so the following section will solely describe the requirements for creating legal entity status as a DAO LLC in Wyoming.

To form a DAO as an LLC in Wyoming, the DAO has to file articles of organization with the Wyoming Secretary of State. The articles of organization require the organization's name to include “DAO LLC” or some variation including a combination of “DAO” or “LAO” with “LLC, L.L.C., Limited Company, Ltd. Liability Co., Ltd. Liability Company, L.C., LC, or Limited Liability Co.” The name and address of a registered agent has to be provided, where the address must be in Wyoming.

The articles of organization must further include a statement that the entity is a decentralized autonomous organization and a publicly available identifier of any smart contract directly used to manage, facilitate, or operate the DAO. Either a designation that a notice of restrictions on duties and transfers will appear in an

operating agreement or a statement providing the notice must further be included.

Lastly, the articles of organization must have a statement establishing how the decentralized autonomous organization shall be managed by the members, including to what extent the management will be conducted algorithmically. Once the articles of organization and a respective filing fee are filed, the DAO should be granted legal entity status after processing.

Codified Rights and Default Rules in Wyoming

The Wyoming legislation provides that DAO management “shall be vested in its members or the members and any applicable smart contracts.” To the extent the articles of organization or a smart contract do not otherwise provide for a matter described in W.S. 17-31-106, the obligations, rights and duties of the members and operation of a decentralized autonomous organization may be supplemented by an operating agreement, where that operating agreement may be a smart contract. The law further requires that any smart contracts used must be “capable of being updated, modified or otherwise upgraded.”¹⁴

If the articles of organization, operating agreement, or smart contract do not specify membership: a person shall be considered a member if the person purchases or otherwise assumes a right of ownership of a membership interest or other property that confers upon the person a voting or economic right within the decentralized autonomous organization; and the person shall cease to be a member if the person transfers, sells or alienates all membership interests or other property that confers upon the person a voting or economic right within the decentralized autonomous organization and retains no further right of ownership therein.

The statute presumes that because the DAO’s records will be open on the blockchain, member do not have the right to inspection of records. Further, there are no default fiduciary duties of the members as the notice of restrictions on duties and transfers provides that the articles of organization, operating agreement, or smart contract can reduce or eliminate such duties.

While a DAO can now obtain legal entity status, there can be certain disadvantages. For example, Wyoming provides that besides other standard provisions for dissolution, the DAO LLC will

dissolve if the decentralized autonomous organization has failed to approve any proposals or take any actions for a period of one year.

Further, Wyoming requires stating premature operational decisions, such as choosing between having the DAO LLC member-managed or algorithmically managed. However, the advantages of registering a DAO may surpass these disadvantages. Advantages can include easy and relatively inexpensive establishment process, regulation by flexible state common law, potential to limit liability to its members, and “pass-through” tax system.¹⁵ As this is a relatively new organizational structure being employed, consultations with a legal practitioner in the field can help mitigate risks when navigating this ever-changing legal landscape.

Conclusion

New rules and regulations are seemingly being determined with enforcement activities of certain federal agencies rather than through “informal rulemaking” under the Administrative Procedure Act or through the legislature. As described above, the CFTC’s enforcement action against Ooki DAO has generated both procedural and substantive questions, such as how to serve notice on a DAO and how members are defined for liability of a DAO’s actions.

Conclusion of the *Commodity Futures Trading Commission v. Ooki DAO* case may answer some of these questions and set precedent for DAOs. In addition, there are now ways to form the DAO as a type of LLC in order to obtain a legal entity status in the United States, and additional states may follow in passing legislation similar to Wyoming or Tennessee. Each DAO may weigh the advantages and disadvantages in determining whether to register as an LLC and within which state.

Notes

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