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Things to Know About Becoming a DAO — and the Importance of Transparency

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Some of the most interesting companies in the world today lack the characteristics of a typical corporate enterprise. They don't use a hierarchical leadership model, decision-making is not carried out by a central authority such as a CEO and, instead of employees bound by legal contracts, autonomous participants are reimbursed through smart contracts. These companies, known as decentralized autonomous organizations (DAOs), operate as internet-native structures that are collectively owned and operated by their members.

The past four years have seen a surge of innovative startups in the blockchain industry, and many are decentralizing their operations and decision-making by forming a DAO led by token holders. Chief financial officers and other C-level executives considering a switch to a DAO should understand the structure and the key issues they will face, including the importance of transparency around token supply and internal treasury management. To help, we've outlined some key points below.

Why Do Blockchain Startups Become DAOs?

Many crypto-native enterprises evolve into DAOs as part of a natural progression that is not possible in traditional corporate structures. DAOs take advantage of the fundamental transparency of public blockchains and the impartiality of smart contracts to decentralize existing power dynamics and to collaborate in a global context. At their core, blockchain networks democratize data sharing. In the same ethos, the companies on these networks are similarly trying to democratize ownership of the platforms they have created. DAOs organize as loose groups working on a common goal or product, and this simplified operating structure remains the same whether they are a small group of friends collaborating on a side project, a social initiative group or a community with thousands of members working on a top crypto protocol. By organizing efforts through a decentralized organization, these startups are able to efficiently allocate human capital without bureaucratic barriers.

Individuals are not siloed in their specialty areas and can interact across the community, including core team members, developers, frequent users and general supporters. Discussions, which are open to all members, might include everything from high-level roadmap decisions to simply providing feedback for the latest platform update. Through their seemingly informal structure, DAOs are meant to be resilient and flexible while also fostering community-centered contribution and ownership.

Recent examples

Currently some of the largest crypto-native startups are decentralized finance (DeFi) protocols such as Uniswap, Aave and Yearn. Like tech startups in the 2000s, these organizations began with a few people pursuing a novel technology and quickly grew to multi-billion-dollar market capitalizations. As of September 2021, according to DeFi Pulse, organizations running DeFi protocols and governed at some level as a DAO managed approximately $100 billion in value — up five-fold in just one year.

And, in a bold move, one of the largest and oldest U.S. cryptocurrency exchanges, ShapeShift, announced in July 2021 that they will dissolve their corporate structure and switch to a DAO in 2022. As a first step in their DAO evolution, ShapeShift airdropped governance tokens (see below) to current customers and others.

How Is a DAO Governed?

Members of a DAO discuss ongoing activities through recurring meetings and/or in a group messaging app (like the Discord app) and use a dedicated online forum for formal proposals. Many DAOs manage official decision-making through a governance token, typically following the ERC-20 standard, and an implementation of on-chain voting (i.e., one token equals one vote).

The distribution mechanism for these tokens varies across projects, but the tokens are frequently used to vote on major decisions regarding operations, roadmaps or treasury management.

Each DAO determines its own threshold to trigger on-chain voting, reaching quorum and processes for implementing approved decisions. There is wide variability in current practice and an active evolution in what is possible in DAOs.

DAO Tokenomics

As mentioned above, the most basic use of a governance token is to vote on important organizational decisions. However, when combining cryptocurrencies with digital ownership rights, projects have started experimenting with alternative uses for governance tokens, including to enable profit sharing.

Upon the token announcement, a project will typically include a chart, or vesting schedule, laying out the inflation schedule and the projected allocation across investors, team members, public/private sales and some unallocated portions for the community to decide.

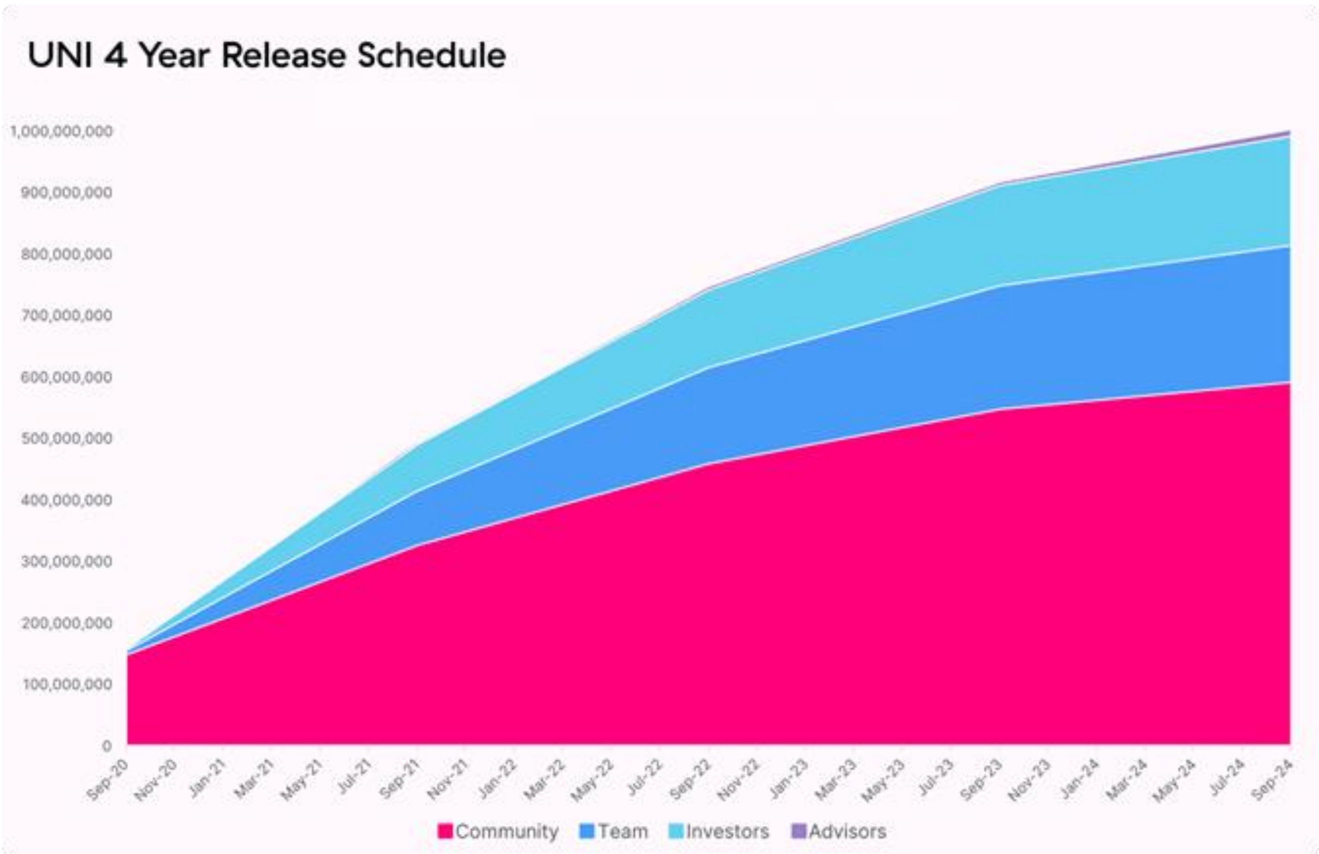

Figure 1: An example of a vesting schedule for Uniswap's UNI governance token, which provides a big-picture overview of estimated token allocations. Source: [Uniswap.org]

Why Is There an Unreleased Supply of Tokens?

There are a variety of reasons why a startup with a native token may choose to have a multi-year release plan for their token supply, including:

Maintain Sybil resistance

Sybil resistance prevents the creation of multiple fake identities that are secretly controlled and operated by a single entity to increase its voting power. A completely released token supply could lead to governance manipulation where a small group of early buyers are able to dramatically influence decisions made in the DAO. In the most extreme case, a single party could attempt to control a majority stake (greater than 50%) in the DAO.

Enable venture capital vesting contracts

Tokens may be allocated on a vesting schedule for early investors to be paid out. Contractual vesting agreements require venture capital firms/angel investors to maintain long-term alignment and support for a project beyond a successful launch. A token allocation with no contractual obligation could lead to early investors propping a project long enough to sell their share at a profit but in turn collapsing the community.

Create community incentives

Unreleased tokens can be allocated to bootstrap users or liquidity by offering “yield farming” incentives. These incentives can come in the form of offering the native token as a bonus for market makers adding liquidity on decentralized exchanges (DEXs) or to attract new users to the platform. Additionally, a DAO can allocate a native token supply to pay community contributors and further promote long-term support.

Improving Transparency of the Native Token

As crypto-native companies continue to grow, it is important for them to maintain transparency standards. While a core attribute of these companies is the public nature of their data, tracking token distribution can be tedious and time-consuming. The process of approving community decisions is usually well-documented on DAO forums, and transactions are verifiable on-chain, yet a simple overview of real-time token allocations is not always readily available.

In one approach to this issue, TrueFi, a blockchain-based lending platform, recently partnered with Armanino to build a dashboard providing real-time tracking of their governance token as it is distributed. The dashboard provides a breakdown of token issuance of the TrueFi treasury, bringing detailed transparency. Building similar tools in the future will provide DAO participants and community observers a clear picture of how their native token is distributed and an overview of historical trends.

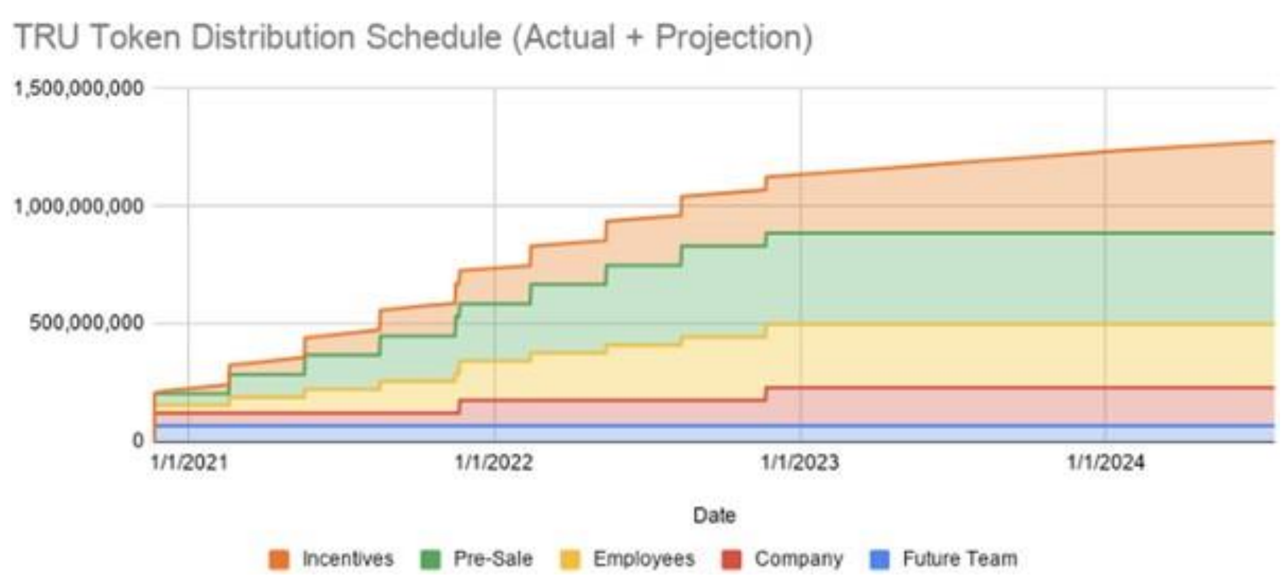

Figure 2: An example from TrueFi’s blog that illustrates an estimated TRU token vesting schedule. Source: TrustToken

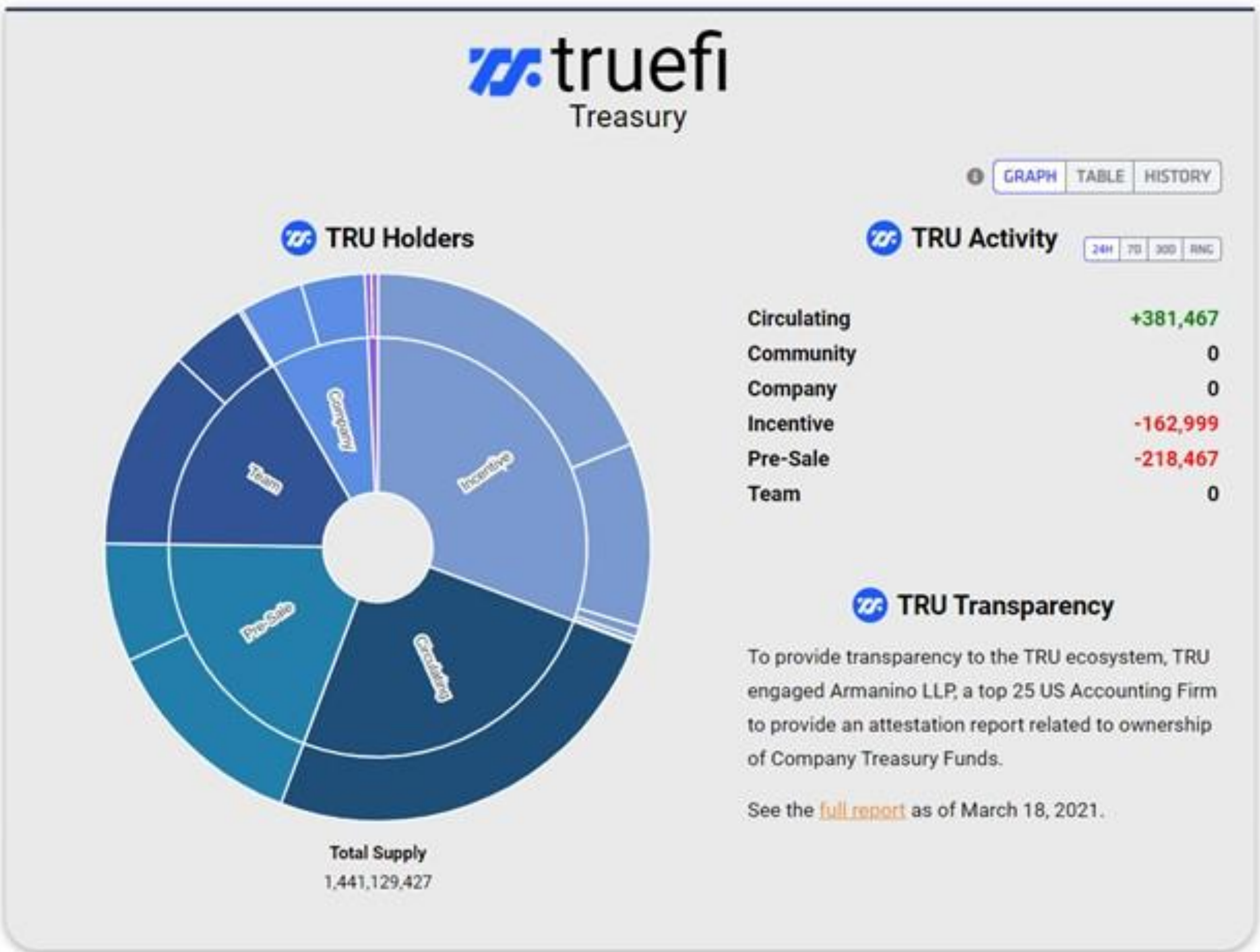

Figure 3: A screenshot of the TrueFi dashboard (clicking the various "pie slices" in the real-time online version provides granular detail about token distribution).

Reporting DAO Financials for Transparency

In addition to managing the ongoing release of their native token, DAOs also must consider their revenue when managing their treasury.

Some of the big crypto startups that morphed into DAOs are amassing significant "war chests." For example, as of September 2021 there was $4.5 billion in Uniswap's treasury and $1.5 billion in Compound's, according to OpenOrgs.info.These reserves have allowed DAOs to invest heavily in new products and community projects and to form a fund to educate global policy makers about DeFi.

While these investments spur innovation right now, history also shows that it is never too early for DAOs to consider contingency plans in case market conditions begin to cool. Several crypto startups that raised billions of dollars at the height of the last bull market in late 2017 saw their treasury reserves crash as their native token and ETH holdings dropped over 90%.

Some companies, like Yearn and Index Coop, are already taking the initiative to publish self-generated reports and dashboards to showcase the revenue of their platforms and the health of their treasuries. Publicizing these metrics will provide tremendous insight to contributors and community members when they are faced with making decisions.

As reporting tools and practices for DAOs become more standardized and available, we can expect more DAOs to take a similar route or potentially work with external parties to certify their financial reporting.

Final Thoughts

Forming a DAO can be viewed as a natural evolution of a blockchain-based startup. By creating a structure that is built on transparency and allows members to share in ownership of the platform through tokens, it takes advantage of the full potential of public blockchains. Smart contracts, which encode the rules of the DAO on the blockchain, also make a DAO's financial transactions public.

You can expect that token holders, investors, employees, the token community and other participants will demand visibility into management of a token project's assets to make informed decisions. More transparency and accountability protects participants, enhances regulatory trust and strengthens the decentralized financial ecosystem by instilling confidence for all market participants.

If you have questions or want to learn more about how our Treasury dashboard can provide transparency around token distribution, contact our Digital Assets team.