

# Decentralized Autonomous Organization under Japanese Law

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## Introduction

Clients often ask us whether it is possible to structure a Decentralized Autonomous Organization (DAO) in Japan. Currently, Japan does not have regulations targeting DAOs, unlike Wyoming State or the Marshall Islands. So, we have written this article summarizing what is typically considered when forming a DAO in Japan.

## 1. DAO

### 1.1 What is DAO?

A decentralized autonomous organization (DAO) is a new legal structure with no central authority and members committed to acting in the organization's best interests. DAOs are used to make decisions in a bottoms-up management style and have gained popularity among cryptocurrency enthusiasts and blockchain technology.

### 1.2 Classification of DAOs

There are several classifications of DAO described below:

#### 1. Investment DAO

Investment DAOs are for-profit DAOs aim at co-investing in a project. They are more likely to attract funds than Grant DAOs because they aim to generate profits mainly through "economic capital."

Examples: Genesis DAO, The LAO, BitDAO, etc.

#### 2. Grant DAO

The community contributes monies to the grant pool and votes on funds allocation and distribution decisions in a Grant DAO. Innovative DeFi projects are funded using these DAOs, showing how decentralized communities are more flexible with funding than traditional organizations.

Examples: MolochDAO, MetaCarteDAO, Aave Protocol, Uniswap Grants, etc.

#### 3. Protocol DAO

When tokens serve as a voting metric for implementing any changes in the protocol, such a governance structure represents protocol DAOs. For instance, MakerDAO has revolutionized the DeFi space with its DAI stablecoin.

Examples: Maker, Compound, Uniswap, Aave, Yearn, Sushi, etc.

#### 4. Service DAO

A Service DAO is a decentralized working group. They can receive tokens as compensation for their projects.

Examples: RAID GUILD, DXdao, PartyDAO, etc...

#### 5. Social DAO

A Social DAO offers digital democracy where opinions are heard, and people can share common interests.

Example: Bored Apes (BAYC)

#### 6. Collector DAO

Artists who use nonfungible tokens (NFTs) to create art rely upon collector DAOs to establish ownership of their art.

Example: PleasrDAO

#### 7. Media DAO

Media DAOs allow product owners of content (i.e., readers) to contribute directly without involving advertisers for the native token as a reward in return for their contributions.

Example: Fore Front (FF), Bankless DAO, etc...

Source <https://cointelegraph.com/daos-for-beginners/types-of-daos>

### 1.3. Example of an Existing Overseas Law

A few places where DAOs are regulated are Wyoming State and the Marshall Islands. Below is a short description of forming a DAO in the Marshall Islands.

#### **The Legal Form of a DAO on the Marshall Islands**

Marshall Islands proposes a non-profit corporation (limited liability company) as a legal entity form for DAO, which stands out from the general practice to establish DAO as a foundation. Such a company is established in compliance with the general corporate law of the Marshall Islands with specific features that:

- No part of the income or profit of the corporation is distributable to its members, directors, or officers; and

- Members' ownership of such a company may be defined in such a plain document as the register of members AND in the company's smart contract.
- You must clearly state the company's purpose and connect it to the non-profit activity. The purpose will be furtherly indicated in the Certificate of Incorporation.

### **How does this work?**

Generally speaking, such a company works as a limited liability company managed by its members. It has three essential constitutional documents: Certificate of Incorporation, Operating Agreement, and Charter of the Company.

The Operating Agreement should include the most crucial matters of your DAO management:

- additional governing bodies;
- voting and counting of votes of such governing bodies;
- amendment of a smart contract;
- creation and management of treasury.

You can amend any of these matters by the members' decision in compliance with the procedure prescribed in the previous version of the Operating Agreement.

### **Registering a Marshall Islands LLC for DAO**

Here's what the process of establishing a legal wrapper for DAO on the Marshall Islands looks like:

- You start by clearly defining the name and purpose of your DAO. Once again, the purpose of your DAO should *indicate the non-profit element*;
- At least three founding members draft the Operating Agreement (you may amend the Operating Agreement at any time upon establishment of the company; therefore, it is a common practice to use the template at the first stage to speed up the process);
- The founding members should pass the KYC process with the local regulator. Apart from the founders, anyone who holds 10% or more governance rights over the company must pass the KYC process;
- The founding members sign the drafted Operating Agreement, Certificate of Incorporation, and Foreign Business Investment License form and file these documents with the regulator;
- If everything is alright with the documents, the regulator sends the Charter of the limited liability company to the founders.

The above is a reference from Taras Zharan Web 3 Virtual Legal Officer.

<https://legalnodes.com/article/marshall-islands-llc-as-a-dao-legal-wrapper>

## 2. Financial Regulations on DAOs

### 2.1. Points to Consider

When structuring a DAO, one must consider the financial regulations and the legal form characteristics.

Here are several points to keep in mind:

1. Security regulation under the Financial Instrument and Exchange Act (“FIEA”) may apply when tokens have the possibility of dividends or redemption of the principal of more than 100% (dividends and redemption of the principal of more than 100% are from now on collectively referred to as "dividends, etc."). As a general rule, token sales of such DAO must be conducted by a Type 1 Financial Instrument and Exchange Business Operator (“Type I license”) or by obtaining a Type 2 Financial Instrument Exchange Business Operator license (“Type II license”).

2. When selling Fungible Tokens without dividends, etc., it is necessary to have a Crypto Asset Exchange Operator conduct the sale or to obtain a Crypto Asset Exchange Operator license. In contrast, these financial regulations generally do not apply when selling NFTs without dividends, etc.

3. You also need to consider the tax benefits. If you want to pursue tax advantages in an Investment DAO with dividends, etc., you can use a partnership or GK-TK scheme. If tax advantages are not particularly important, an association without rights, a general incorporated association, or a limited liability company can be considered a scheme to issue tokens. For the issuance of Fungible tokens or NFTs without dividends, etc., it may be better to have no particular legal structure.

### 2.2. Reference Table of Conclusions

The table below summarizes the legal scheme and financial regulations that should be considered in establishing a DAO.

The following regulations apply to token sales of Investment DAOs with dividends, etc. (assuming dividends or principal redemption of more than 100%).

Type of Member’s Rights	Form under Japanese Law	Free distribution of Tokens	Token Sale	Investment Management
DAO member’s rights as shareholders’ rights in Limited Liability Companies and	Tokenization of shareholders’ rights of limited liability companies, etc.	Free distribution of the shareholders' rights is not allowed under	Sales by a third party for an issuer need a Type I license. A Type II license is necessary for the self-offering of a limited liability	No regulation

Joint-stock Companies		corporate law, etc.	company. No license is required in the case of self-offering of a joint-stock company.  In the case of solicitation of 50 or more people, there needs to be a submission of a registration statement regarding securities, etc.	
DAO member's rights (with dividends), not including shareholders' rights	TK investment, partnership investment, tokenization of rights that are difficult to classify into prescribed legal forms, etc.	Unregulated	Sales by a third party for an issuer need a Type I license. Self-offering needs a Type II license. In the case of solicitation of 50 or more people, there needs to be a submission of a registration statement regarding securities, etc.	No regulation  (Possibility of Investment Management Business license in the case of securities investment)

On the other hand, a DAO without dividends, etc., is also possible. Its regulations are as follows:

Tokens/NFT	Free Token Distribution	Sale of Tokens	Investment Management (Assuming no dividend)
Utility Tokens	No regulation	Crypto Asset Exchange Business regulation	No regulation
NFT	No regulation	No regulation	No regulation

With respect to possible legal forms for DAOs, the following comparisons can be made:

Status	Legal Form	Limited Liability	Is it possible to distribute?	Avoid Double Taxation	Others, Comprehensive Evaluation
No Legal Entity Status	Association without rights +Tokens with unclear rights	○?	○	×	△~○ High degree of freedom. A good scheme if there is no problem with double taxation.
	Civil Law Partnership + Partnership Equity Token	×	○	○	△~○ High degree of freedom. A good scheme if there is no problem with limited liability.
	Investment Business Limited Liability Partnership + partnership Equity Token	○	○	○	×
	Limited Liability Partnership + Partnership Equity Token	○	○	○	×
DAO has Legal Entity Status	Corporation (*1) + Tokenization of Anonymous Partnership (e.g., TK-GK scheme)	○	○	○	△ It is necessary to operate in accordance with the Companies Act and the General Incorporated Associations Act. It should be noted that TK holders do not have the right to instruction. The good point is that there is no double

					taxation and limited liability.
	Corporation (*1) + Token with unknown rights	○?	○	×	△ ~ ○ It is necessary to operate under the Companies Act and the General Incorporated Associations Act. Besides that, it has a high degree of freedom and is a good scheme if you don't mind the double taxation problem.
	Corporations (*1) + Tokenization of shareholders rights (*2)	○	○ (× For general incorporated associations)	×	× Is there a low degree of freedom due to the need to operate per the Companies Act and the General Incorporated Associations Act? For example, it is necessary to manage members as shareholders.

\*1 Legal entities include limited liability companies, stock companies, and general incorporated associations. LLCs are generally easier to establish and operate than joint-stock companies. If you want to have a more public image, use a general incorporated association.

\*2 Membership rights of a limited liability company, stocks of a stock company, membership rights of a general incorporated association.

### 2.3 Tokenization of Rights

Tokenization of rights of funds or partnership, where there is an investment of funds (including money and crypto assets), investment management, dividends, or redemption of the principal of more than 100%, would be broadly considered a collective investment scheme (fund) under Japanese law. Below is the summary of the Definition of a Collective Investment Scheme.

Summary of Definition of Collective Investment Scheme
Rights that satisfy the following (i) to (iv)
(i) Rights under a partnership agreement as defined in Article 667(1) of the Civil Code, a silent partnership agreement as defined in Article 535 of the Commercial Code, an investment limited partnership agreement as defined in Article 3(1) of the Act on Limited Liability Partnership Agreement for Investment Business, or a limited liability partnership agreement as defined in Article 3(1) of the Act on Limited Liability Partnership Agreement for Investment

Business, incorporated association (i) Rights of members of a juridical person, and other rights;
(ii) The existence of a business (the "Invested Business") in which money (including cryptographic assets) contributed or contributed by the person who has such rights (the "Investor") is allocated to the Invested Business;
(iii) The investors are entitled to receive dividends of profit generated from the invested business or distribution of assets related to the invested business;
(iv) There are no exceptional circumstances, such as all investors being constantly involved in the business.

The revised Financial Instruments and Exchange Act, which came into effect on May 1, 2020, created the legal concept of Electronic Record Transfer Rights. The rights of tokenized collective investment schemes usually fall under the Electronic Record Transfer Rights below.

<b>Outline of Definition of Electronically Recorded Transfer Rights</b>
Rights that satisfy the following (i) to (iii) but exclude (iv) (Article 2, Paragraph 3 of the FIEA): (i) Rights listed in each item of Article 2, Paragraph 2 of the FIEA (funds, trust beneficiary rights, members' rights of general partnerships, limited partnerships, limited liability partnerships, etc.); (ii) When they are expressed in property values that can be transferred through an electronic data processing system; (iii) When recorded in electronic devices or other objects by electronic means; (iv) Cases provided in the Cabinet Office Ordinance have considered the nature of distribution and other circumstances.

The sale of this electronic record transfer right requires a Type 1 Financial Business registration. If soliciting more than 50 people, it will be a public offering (Article 2, Paragraph 3 of the Financial Instruments and Exchange Act), and a securities registration statement must be submitted based on Article 5 of the FIEA.

If the sale is limited to qualified institutional investors or wealthy people of 49 or less, and even if there is resale, there are technical restrictions so that other people cannot become DAO token holders.

When the Investment DAO is formed, it can be sold in such a limited form at first, and after it grows, it can be sold to the general public while complying with increased regulations.

## **2.4 Tokenization of Company Membership Rights and Financial Registration Regulations**

Regarding tokenization of company membership rights, a Type I FIBO license is necessary when a third party sells the rights, and Type II is essential in the case of self-solicitation. In the case of tokenization of company membership rights (shareholders rights) of a joint stock company, a



Type I license is necessary in the case of solicitation by a third party, and no license is required in the case of self-solicitation.

**2.5 Regulations on Public Offerings, etc.**

If any of the following applies, it becomes a public offering. In principle, it is necessary to submit a securities registration statement.

- (i) When soliciting the acquisition of securities from 50 or more persons (excluding Qualified Institutional Investors (QII) in the case there are restrictions on resale other than QII);
- (ii) When it does not fall under any of the following categories: Private Placement for QII, Private Placement for Professional Investors, and Private Placement for Small Groups.

**2.6 Financial Regulations for DAOs without Dividends**

If DAOs have no dividends, etc., they are not considered securities, but different financial regulations may apply.

Tokens/NFTs	Free token distribution	Token Sales	Investment Management (Assumption without dividends)
Utility Tokens	Unregulated	Crypto Asset Exchange Business License	Unregulated
NFTs	Unregulated	Unregulated	Unregulated

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### Disclaimer

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