Startup Investing and Venture DAOs

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I. Introduction

Venture capital has been the subject of much discussion in recent years, with some claiming that the use of decentralized autonomous organizations (DAOs), a nascent financing and governance structure, could disrupt the industry.[1] In the late 2010s, a new type of DAO called Venture DAOs (VDs) emerged[2] to make venture capital-style investments in traditional startup equities and projects with decentralization, ubiquity, and artificial intelligence characteristics, known as Web 3.0 (Web3).[3] VDs sources capital from large numbers of individual investors, who participate in the investment process through a decentralized, democratic structure.[4] This approach represents a significant departure from VC funds (VCs), which are generally controlled by small independent VC firms and financed by separate institutional investors.[5]

Several discrete legal innovations in the law of corporations have played an essential role in making venture capital a key component of the startup ecosystem and shaping the makeup and incentives of venture investing.[6] One such innovation was the development of the limited partnership for VC investments, which introduced the carried interest profit-sharing mechanism that has incentivized top-tier investment talent to become VCs.[7] Another innovation was the relaxation of investment rules for U.S. pension funds, which unlocked large inflows of capital from pension funds and other institutional investors.[8] It remains to be seen whether

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1 *See* Kauffman Fellows, *Will Investment DAOs Decentralize Venture Capital?*, https://perma.cc/KA6T-4JSZ (last visited Sept. 26, 2022); *see also* Nasdaq, *Can DAOs Democratize Fundraising?*, https://www.nasdaq.com/articles/can-daos-democratize-fundraising (last visited Sept. 26, 2022).

2 *See* Unicorn Nest, *The LAO*, https://perma.cc/5CFN-WVDE (last visited Sept. 26, 2022); *see* Flamingo DAO, https://perma.cc/4FME-XSGM (last visited Sept. 26, 2022).

3 The Investopedia Team, *Web 3.0 Explained, Plus the History of Web 1.0 and 2.0*, https://perma.cc/8ZTS-EBV3 (last visited Feb. 19, 2023).

4 *See* Kauffman, *supra* note 1.

5 *See* ANDREW METRICK & AYAKO YASUDA, Venture Capital & the Finance of Innovation 17 (Jennifer Manias ed., 3d ed. 2021).

6 *Id.* at 7.

7 *Id.*

8 *Id.* at 7–8.

VDs will represent a new legal innovation that will drive further change in the industry.

The foregoing context begs a general question: what is the most efficient organizational form for venture investing? Law and economics provides a strong framework to perform a comparative institutional analysis of VCs and VDs. In this paper, the normative welfare criterion used to evaluate the efficiency of venture investing is that all positive-expected-value ventures should receive financing. To assess VDs according to this criterion, it is necessary to first provide some background context on the characteristics of VDs. Section 3 of the paper then turns to analyzing the incentives of organizers, investors, founders, and established VCs for engaging with Venture DAOs. Section 4 concludes.

II. CHARACTERISTICS OF VENTURE DAOS

VCs and VDs are two types of investment structures with distinct characteristics. VCs are typically composed of independent VC firms that manage VC funds, which are limited partnerships with a finite yet renewable timeline.[9] The firms, which are small organizations averaging about 10 professionals, serve as general partners (GPs) for the funds, while the limited partners (LPs) are mostly institutional investors.[10] In contrast, VDs are online communities that invest in both Web3 projects and traditional startup equities using self-executing contracts called smart contracts.[11] The terms of these contracts are written in code, removing the need for intermediaries[12] and allowing the community to make investments and distribute returns.[13] While both VDs and VCs seek to maximize returns for their investors by supporting the internal growth of portfolio companies and exiting investments at attractive prices, they employ different strategies to achieve this objective.[14] VCs rely on a few consistent top performers to drive profits,[15] while VDs

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[9] *Id.* at 17.

[10] *Id.*

[11] Chris Brummer & Rodrigo Seira, *Legal Wrappers and DAOs* 3 (SSRN, White Paper), https://perma.cc/QB4Y-RHJT.

[12] IBM, *Benefits of smart contracts*, https://perma.cc/QU4C-KLB2 (last visited Feb. 19, 2023).

[13] Jake Frankenfield, *What Are Smart Contracts on the Blockchain and How They Work*, https://perma.cc/RD9J-F5QM (last visited Feb. 19, 2023).

[14] Brummer, *supra* note 11, at 22-23.

[15] METRICK, *supra* note 5, at 73.

pursue their purpose through a participatory approach to investment decision-making.[16]

A. Screening, Supporting, and Exiting Activities

VDs and VCs engage in three key activities to maximize return on capital: screening, supporting, and exiting activities.[17] Unlike VCs, VDs carry out these activities through a decentralized community of investors, elevating community management as a fourth key activity.[18] Since exiting activities are similar for both structures, the analysis below focuses on how VDs and VCs screen and support investments.

Screening activities refer to the VC's ability to source high-quality investment prospects, also called deal flow.[19] Many venture deals involve a syndicate of investors who negotiate and close deals together, leveraging relationships to produce a virtuous cycle of quality deal flow.[20] Some top-tier VCs can generate high-quality deal flow through the sheer force of their reputations because entrepreneurs and other investors want the brand of that top-tier VC attached to their venture.[21] Other reputational benefits include pricing leverage, introductions to top-tier talent, and attractive exit opportunities.[22] Both VDs[23] and VCs[24] rely heavily on reputation to source and syndicate deals, and both investment structures have potential to reduce search costs for founders via a strong brand. For example, V3C DAO is a VD composed of hundreds of well-established venture capitalists.[25]

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16 Alex Lielacher, *Investment DAOs: What Are They & How Do They Work?*, https://perma.cc/RUS3-WXT4 (last visited Feb. 18, 2023).

17 METRICK, *supra* note 5, at 6.

18 Aragon, *What is a DAO community?*, https://perma.cc/N74U-QFLH (last visited Feb. 20, 2023).

19 *Id.* at 118.

20 MARCO DA RIN & THOMAS HELLMANN, Fundamentals of Entrepreneurial Finance 271 (2020).

21 METRICK, *supra* note 5, at 118.

22 *Id.*

23 Peter 'pet3rpan', *Unbundling venture capital via DAOs*, https://perma.cc/PFX7-J8W9 (last visited Feb. 20, 2023).

24 METRICK, *supra* note 5, at 72.

25 Jules Miller, *How 150 VCs created the VC3 DAO for decentralized investing*, https://perma.cc/FS24-6DHZ (last visited Feb. 19, 2023).

VCs and VDs must also excel at supporting their portfolio companies through activities like mentoring, advising, networking, and pressuring.[26] Ideally, founders will be able to tap into the collective knowledge and abilities of a VD's community to harness these benefits. However, while VDs have the unique potential to serve as a source of crowd-sourced feedback on product or business plans, connections to potential employees or clients, productive performance pressure for founders and their management teams, and other operational capacities, they have struggled so far to do so.[27] Indeed, the existence of free riders who exploit the reputations, due diligence, and supportive efforts of other community members may be endemic to VDs without sufficient safeguards put in place.[28] In a VC, while much of the increase in wealth goes to the limited partners, the increase in external reputational benefits are nevertheless more fully captured by the VC general partner compared to its analog in the VD investing context.[29] To mitigate motivational risks, some well-known VDs like Global Coin Research (GCR) employ governance features like giving active or more invested members enhanced privileges, requiring participation in investment decisions, and strict approval processes for bringing in new members.[30]

Questions have thus arisen about whether VDs, composed of mostly non-professional individuals, can consistently produce quality due diligence and returns. GCR has shown a voracious appetite for investing in companies presented to their communities, raising concerns about the quality of due diligence. The VD's members committed $26 million to approximately 25 deals after reviewing 70 deals in the VD's first four months of operation, a conversion rate of 35.7%.[31] In contrast, the probability of moving from screening to investing for VCs is approximately 2%.[32] It remains to be seen whether VDs will be able to build a sense of community and public-spiritedness among investors capable of inspiring systematic quality screening and supportive efforts.[33]

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[26] DA RIN, *supra* note 20, at 309.

[27] Peter 'pet3rpan', *Undbundling venture capital via DAOs*, https://perma.cc/69PV-4WGL (last visited Feb. 20, 2023).

[28] *Id.*

[29] METRICK, *supra* note 5, at 72.

[30] *See* GCR, *GCR Deals – FAQ*, https://perma.cc/WMD6-CWRE (last visited Feb. 19, 2022).

[31] GCR, *$GCR Community Deal Access: Some Stats*, https://perma.cc/5HQF-5RDC (last visited Aug. 8, 2021).

[32] DA RIN, *supra* note 20, at 269.

[33] Peter 'pet3rpan', *supra* note 23.

B. Governance by Smart Contract

Smart contracts underpin VDs, but their use in coordinating investment and governance activities can vary.[34] A VD is often set up as a participatory DAO, which aggregate member votes using smart contracts, as opposed to an algorithmic DAO that uses code to automate the entire DAO's functionality including management, social interactions, and governance functions traditionally provided by boards and written legal documents.[35] For example, The LAO uses smart contracts to facilitate governance functions such as: (1) collecting members' initial contributions to The LAO; (2) voting; (3) delegating voting to third parties;[36] (4) funding investments;[37] (5) distributing proceeds;[38] and (6) rage quitting."[39] The LAO simultaneously retains and relies "on a service provider (initially, OpenLaw) to facilitate various administrative functions on behalf of its members."[40] The LAO's operating agreement was also prepared by OpenLaw's outside counsel.[41] Despite the apparent benefits of smart contracts, then, smart contracts do not render existing legal contracts or legal processes obsolete.

VDs' model of corporate governance in an investment context presents myriad legal risks, and VDs are subject to greater regulatory burdens than non-investment-oriented DAOs.[42] VDs face the risk of being deemed "general partnerships" because VD members have full management control of the entity,[43] subjecting members to unlimited liability if the entity harms a third party or is unable to pay creditors.[44] As such, to provide members with limited liability, VDs have mainly organized as Delaware LLCs.[45]

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34 Aaron Wright, *The Rise of Decentralized Autonomous Organizations: Opportunities and Challenges*, 4 Stan. J. Blockchain L. & Pol'y 152, 156 (2021).

35 *Id.*

36 The LAO, *Voting Rights*, https://perma.cc/4J78-EPT9 (last updated Mar. 9, 2021).

37 The LAO, *Projects*, https://perma.cc/4YNA-ZXRC (last updated Mar. 9, 2021).

38 *Id.*

39 The LAO, *Smart Contracts*, https://perma.cc/4XHB-GW37(last updated Jan. 31, 2020).

40 The LAO, *How is The LAO structured*, https://perma.cc/F45M-KU8H (last updated Apr. 22, 2020).

41 *Id.*

42 Brummer, *supra* note 11, at 22–23.

43 *Id.*

44 Wright, *supra* note 34, at 167 (citing RUPA § 202a (Nat'l Conference Comm'rs of Unif. State Laws 1997)).

45 Brummer, *supra* note 11, at 22.

The previously mentioned "rage quitting" mechanism offered by some VDs also raises regulatory concerns about whether the VD ownership interests are publicly tradeable securities under SEC purview.[46] Rage quitting could trigger statutes prohibiting members from taking "improper distribution," particularly if pending liabilities exist.[47] The incorporation of legal text from an operating agreement may also create potential ambiguity about the operation of the VD's underlying smart contracts.[48] The LAO states that members shall not have any fiduciary duty to The LAO or any other member and that under the operating agreement, members agree to interact in good faith and to engage in fair dealing,[49] but there remains potential ambiguity since fiduciary duties are traditionally used as gap-filling mechanisms in the law.[50]

Another fundamental question is whether VDs qualify as investment companies under the Investment Company Act of 1940 (the Act),[51] which provides actions in the event of fraud or breach of fiduciary duty, and requires different types of investment companies to register with the SEC and abide by a host of specific rules before they can offer their products to the investing public.[52] VC funds are generally excluded from the Act by satisfying the exclusions of Section 3(c)(1) and Section 3(c)(7).[53] To avoid the regulatory burdens of the Act, some VDs have sought qualification as an investment clubs by including limitations like a cap on members and requiring all members actively participate in decision making.[54]
Against this backdrop of legal uncertainty, one might ask whether the democratization of venture investing is normatively desirable. Arguably, differences in the characteristics of VD investors (i.e., they could be literally any random person off the street) and those of VC fund investors justify different regulatory treatment for VDs under the Act.

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46 Wright, *supra* note 34, at 162.

47 Brummer, *supra* note 11, at 22.

48 Wright, *supra* note 34, at 171 (citing Harry Surden et al., *Managing Representational Complexity in Computational Law* (2018), https://perma.cc/7NGR-NWWA).

49 The LAO, *Organization*, https://perma.cc/B3NE-3WA5 (last updated Apr. 22, 2020).

50 Wright, *supra* note 34, at 170-171 (citing Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & Econ. 425, 427 (1993).

51 *Id.*

52 James Chen, *Investment Company Act of 1940 Definition*, https://perma.cc/A6NF-9VNH (last visited Feb. 18, 2023).

53 James Chen, *3C1*, Investopedia, https://perma.cc/X9KE-LJ6N (last updated Mar. 27, 2022). *See also* 15 U.S.C. § 80a–2.

54 Brummer, *supra* note 11, at 22.

III. MOTIVATIONS FOR ENGAGING VENTURE DAOS

A. Organizer, Investor, and Founder Incentives

Another question concerning Venture DAOs relates to the incentives of existing stakeholders in the venture industry to engage with them. Most DAOs either implicitly or explicitly assert that they are trying to "increase access" or "democratize" venture capital so that less economically powerful people can participate in private equity-style investing.[55] Venture DAOs frequently employ operating strategies that focus on transforming the shared identity of their organizers into a comparative advantage. Consider the case of Orange DAO, a Venture DAO initiated by a group of alumni from the prestigious Y-Combinator startup incubator which limits its membership by smart contract to other alumni.[56] Other DAOs change tack by integrating an impact investing component that emphasizes the social or environmental impact of projects: for example, Komorebi Collective prioritizes investing in female and non-binary crypto founders.[57] The primary reasons for joining a VD are thus the opportunity to earn profit and participate in a startup or Web3 project's unique community.

Founders may find VDs attractive as a rich and more accessible source of support, advice, connections, and capital.[58] Indeed, VDs may enable founders to access capital at a lower cost than from VCs; as mentioned previously, the potential lack of sophistication characterizing VDs, whose communities are more likely to invest in projects out of fear of missing out, could lead such investors to accept prices that are higher the project's fundamentals.[59] If VD investors are irrationally optimistic about projects' economics, the resulting lower cost of capital would lead to more projects for which expected returns are lower than costs being funded.[60] This windfall to less-deserving founders would result in VDs performing less well

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[55] Nevertheless, ownership of Venture DAOs remains concentrated under the ownership of a few individuals. GamesBeat, *Chainalysis: Web3 ownership of DAOs is surprisingly concentrated*, VentureBeat, https://perma.cc/Y543-35KM (June 27, 2022).

[56] Anita Ramaswamy, *Y Combinator alumni raise $80 million for DAO to back crypto startups*, TechCrunch, https://perma.cc/G49Z-TTH6 (last visited Aug. 23, 2022).

[57] KomorebiFund, *Komorebi Collective*, Syndicate, https://perma.cc/56S7-KGHR (last visited Sept. 10, 2022).

[58] Kauffman, *supra* note 1.

[59] For a helpful discussion of the panic buying resulting from fear of missing out psychology, *see* James Chen, *Panic Buying: Meaning, Psychology and Implications*, https://perma.cc/D6FU-YBLX (last updated April 25, 2022).

[60] Adam Hayes, *Irrational Exuberance: Definition, Origin, Example*, https://perma.cc/MEC3-3TEM (last visited Feb. 20, 2023).

than VCs, which would be a suboptimal outcome according to our normative criterion of financing all ventures that have positive expected value.

B. VC Incentives and Service DAOs

Despite the efficiency concerns just described, there is yet potential for DAOs more generally to complement and enhance the activities of VCs themselves. DAOs are well-positioned to form around *existing* VCs and their associated networks of invested startups, LPs, operators, and audiences.[61] As mentioned previously, there are VDs like V3C that have been formed by sophisticated venture capitalists.[62] This paper also identifies a new type of VDs called "Service Venture DAOs" or "SVDs" that concentrate on providing the previously discussed non-investment value-add activities of venture investing. For example, in 2022, VC fund Bessemer Ventures announced $250 million dollars in investments to "[forge] the decentralized future"[63] as well as the launch of BessemerDAO, "a web3 community for founders, creators, and operators" with the goals of "help[ing] the crypto community meet talent, trade ideas on product, business development, and tokenomics, extend visibility into where innovation is happening in the crypto space, and ultimately, aid in staying ahead of major shifts and trends in web3."[64] The division of labor between a SVD and its associated VC could mean that the SVD can benefit from the reputation and skills of the VC[65] while the VC can benefit from the operational support of the SVD.[66] Ultimately, the SVD-VC structure may outperform VCs and VDs, even those composed of established professional venture capitalists.

IV. CONCLUSION

There are limits to what scholarship on a topic as current as Venture DAOs can accomplish today. What is clear is that VDs represent a more democratic, potentially compelling set of new approaches to venture capital investing, and VC firms are not sitting idly by. Of course, while VDs may enable a larger number of

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61 Kauffman, *supra* note 1.

62 Jules Miller, *How 150 VCs created the VC3 DAO for decentralized investing*, https://perma.cc/FS24-6DHZ (last visited Feb. 19, 2023).

63 Bessemer Venture Partners (@BessemerVP), TWITTER (Mar. 10, 2022, 2:14 PM) https://perma.cc/AE3K-2AFF.

64 The Bessemer Partners, *Forging the decentralized future: Bessemer's commitment to web3*, https://perma.cc/X2J5-2BJK (last visited Feb. 19, 2023).

65 Crypto & web3 Team, *Building the future of decentralized computing and Web3*, Bessemer Venture Partners, https://perma.cc/AZ4M-AHCW (last visited Sept. 23, 2022).

66 *Id.*

people to participate in the activities associated with venture investing, including not just the investing itself but also sourcing, supporting, and exiting, the *proportion* of venture investors generating outsize returns is not likely to change dramatically given the long tail that characterizes the venture investing talent distribution. Perhaps, then, the most serious challenge to currently established VDs is not from impending regulation, as often thought, but rather competition from VC firms experimenting with launching their own VDs and Service Venture DAOs. Indeed, GCR, The LAO, BessemerDAO, V3C, Orange DAO, and other venture industry participants launching DAOs offer an opportunity to reconsider how the venture capital industry operates and when alternative approaches could be competitively advantageous.