A Beginners' Guide to DAOs

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In these article, we walk you through all the things you need to know to get caught up on DAOs.

What Exactly Is a DAO?

Think of a DAO as a digital organization that exists on a blockchain. There is (usually) no restrictions as to who can join the DAO, as long as they have something that they plan to contribute.

To become a member of a DAO, however, you must purchase the governance tokens of that DAO. Subject to the proportion of their governance tokens, DAO token holders can vote on key decisions that the DAO takes.

Now, just as any other human organization where almost anyone in the world can join, DAOs are often made up of people from myriad backgrounds. A DAO does not require users to provide any KYC-related information, which essentially means the DAO members can truly remain anonymous and still continue to contribute to the organization.

The purpose of a DAO can be anything: a self-fostering community of developers who share tips and tricks amongst each other and further train upcoming developers; a decentralized venture fund which collectively funds emerging protocols in DeFi; the list goes on.

As we just said, the purpose of a DAO can truly be anything — as long as it has something through which the members can vote (in most cases, a governance token). All the actions of a DAO — from its operations to management — are written into code: it is a self-governed entity.

Now, there are certain crucial distinctions that we must make to understand what a DAO is and what a DAO isn't. For this, we will have to move into more confusing waters. Bear with me as I break things down.
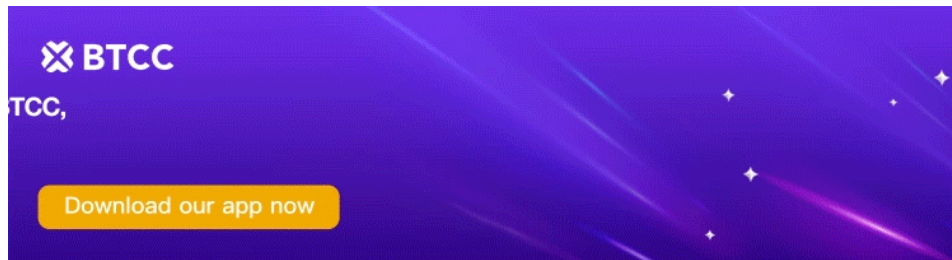
Are DAOs Just Smart Contracts?

No, it's not. A smart contract differs from a DAO because it involves a limited number of participating entities, whereas a DAO can potentially have n number of entities that participate in it. It might be argued that there are some contracts which have an infinite number of participants, but there is another crucial difference.

A smart contract is activated only when a user initiates an execution on the level of the smart contract. If the smart contract does not receive that stimulus from the user, then it lays dormant. While the same can be said for a DAO, the truth is that DAOs can have multiple processes going on without the need for an external stimulus. Since a DAO is a self-contained organization, its entire function is managed internally.

That said, DAOs can often have their rules of governance written into smart contracts.

How Do DAOs Work?

As the name suggests, DAOs run autonomously by using smart contracts to execute its rules as defined by its creators. Although the creators of every DAO write its initial code, once it launches it's up to the community to decide on how the organization operates.

Conversely, centralized organizations like Amazon host board meetings where shareholders vote on crucial decisions and the direction of the company. The CEO then ensures the decisions are carried out.

But in a DAO, there are no CEOs, nor is there a rigid hierarchy.

Every DAO token holder can submit changes, hold votes and influence the DAOs direction merely by holding tokens. The more tokens you hold — the more votes, and therefore influence — you have over the DAO.

When a change to the code or a new feature is approved through a vote, the DAO changes immediately. This allows code to carry out routine operations like hiring and firing for which centralised organisations need people.

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Why DAOs Attract our Attention?

DAOs offer entrepreneurs and innovators numerous long and short-term benefits that a traditional corporate structure cannot.

By carrying out business operations autonomously through smart contracts, DAOs are trustless. They don't require you to put your faith in an individual or a boardroom of directors. Should an important developer or manager leave, the DAO will keep going.

DAOs are also censorship-resistant. They cannot be forcibly shut down by anyone, including government or regulatory bodies. Even the DAO's creators cannot shut it down without the community of governance token holders approving the shutdown through a vote. Nobody can impose their will onto a DAO regardless of their position or authority.

DAOs offer many long-term benefits, too. They allow anyone holding a governance token to partake in the success of the project by contributing to the DAOs mission in a wide range of ways. These could include developing new code or features, fixing bugs, or contributing capital to an investment pool, among many others.

Should DAO creators establish and maintain a strong community culture, rather than focus on

creating profits at all costs, they could encourage social incentives and increase participation and contributions from their communities.

What Are the Main Challenges Facing DAOs?

We already considered one key issue with governance for DAOs earlier when we discussed how someone who has a specific threshold of governance tokens within the DAO can influence the decisions of the DAO in their favor. This can be counteracted with a reputation mechanism —but there could potentially be a scenario where a key member of the DAO can acquire a reputation within the DAO only to abuse it later on.

We have already seen how CurveDAO facilitates this reputational problem: with CurveDAO, the longer you lock your tokens in, the greater your voting power gets. Thus, any protocol that wants to increase their presence within the Curve protocol can simply bribe these holders to vote in their favor. A similar case occurred with Mochi Finance just a few weeks ago.

In most cases, however, reputation serves as a key solution to the problem of voting power centralization. Most rational agents of a DAO with a high value of reputation power will mostly be unbiased in their decisions — as several cases in the past have proven. Also, the fact that other members of the DAO look up to them in key decisions gives them a moral obligation to be fair. Furthermore, reputation scores (or tokens even) are a non-transferable asset. Therefore, a devious entity cannot buy that reputation.

There can be extreme cases where an entity with high governance power and reputation dominates the DAO's decisions, but that is more of an extreme case.