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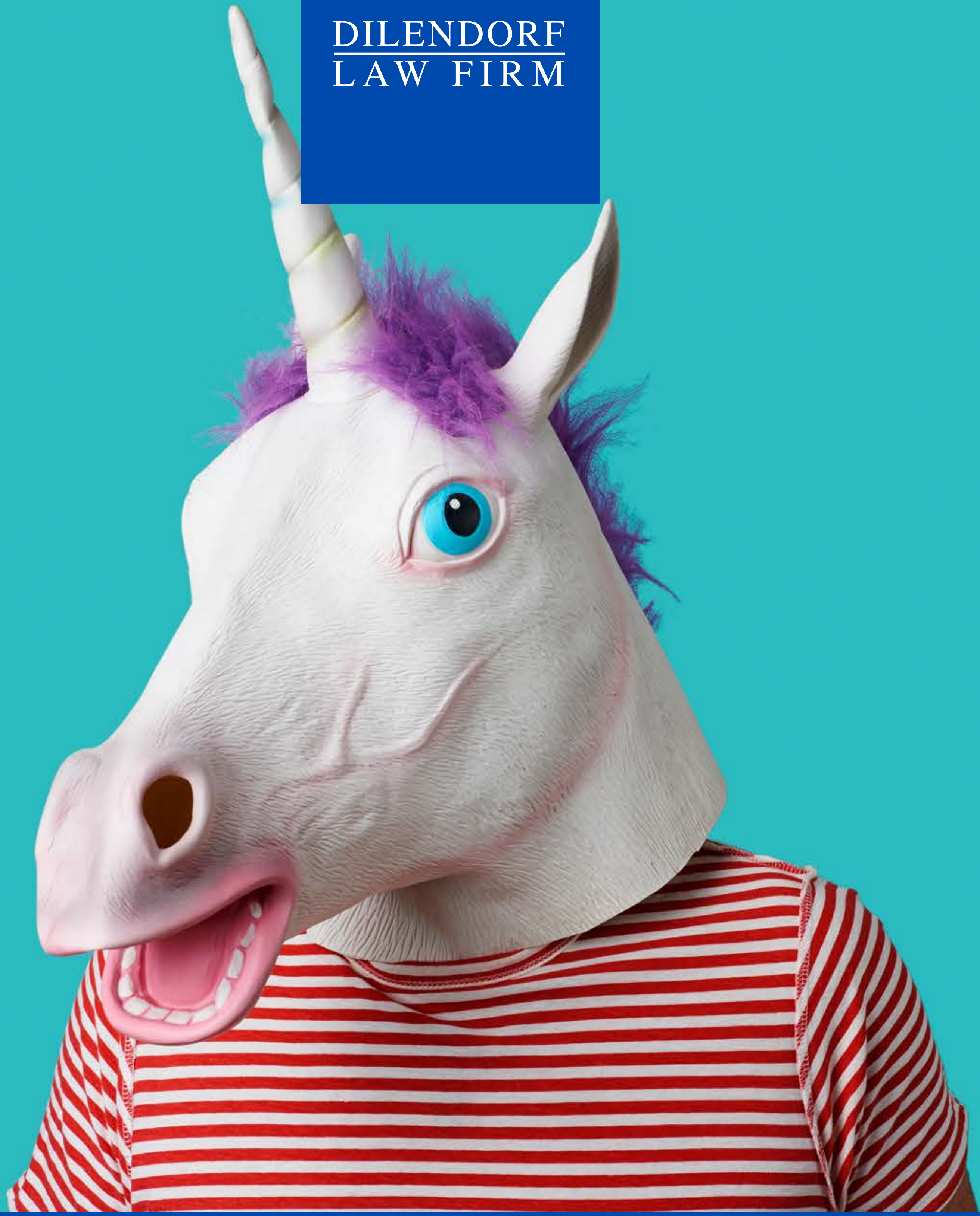

Uniswap — An illusion of decentralization?

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Introduction

Authors: Max Dilendorf, Esq. and Kareem Tabba

Decentralized Finance (DeFi) has made great strides over the last year. In fact, the Total Value Locked (TVL—a statistic representing the number of assets staked in a particular protocol and one of the most important indicators to assess the overall growth rate of DeFi—across all DeFi platforms has grown from a relatively paltry $1 billion in June of last year to over $60 billion today (peaking at over $86 billion in mid-May)).

Proponents of the movement see it as an opportunity to democratize finance, bringing the system out from under the control of central authorities like the US government and big banks and putting it into the hands of the community.

But whether these "decentralized" platforms are actually what they claim to be—that is, trustless and without a central controlling authority—remains an open-ended question subject to much debate.

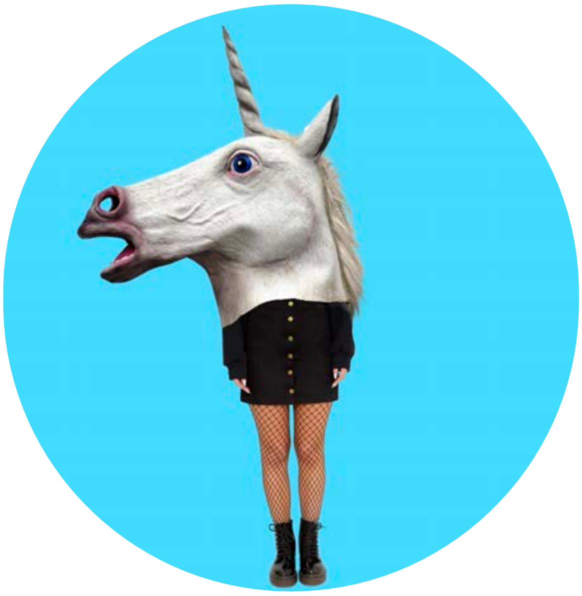
Uniswap, a pioneer of the DeFi movement, is one of the largest DeFi platforms operating on the Ethereum blockchain and portrays itself as a champion of decentralization.

The Uniswap platform operates as a decentralized exchange that incentivizes users of the protocol to maintain liquidity in its liquidity pools by providing portions of the transaction fees and newly minted UNI tokens to those who participate. Since its inception, three iterations of the platform have been released by Uniswap Labs, the team responsible for the protocol.

According to Cryptofees, the third version of Uniswap, Uniswap v3, generates an average of $3 million in transaction fees on a daily basis—the second most of all crypto projects running on the Ethereum blockchain today. Uniswap v2, the second iteration of the decentralized exchange which continues to operate, is not far behind, generating an average of approximately $1 million daily in transaction fees.

In February of 2021, Uniswap became the first DeFi platform to process over $100 billion in volume. And in April of 2021, Uniswap surpassed $10 billion in weekly trading volume, which would amount to over half a trillion dollars per year.

It is safe to say that Uniswap processes an immense number of transactions amounting to hundreds of billions of dollars. But the platform and its team, Uniswap Labs, have been left to operate without regulatory scrutiny.



Uniswap Labs describes the Uniswap protocol as a "trustless and highly decentralized financial infrastructure." But is Uniswap as decentralized and trustless as the Uniswap Labs team make it seem? For one, Uniswap Labs not only developed the code for Uniswap v3 but also promoted the launch of the platform to the public.

What is more, Uniswap Labs operates a centralized User Interface and consistently promotes Uniswap and new developments or changes to the protocol and interface. Not to mention the fact that Uniswap Labs airdropped 150 million UNI tokens—Uniswap's native governance token—to historical users and liquidity providers of the protocol in September of 2020.

And while Uniswap's "Governance Protocol" is depicted as a way to transfer governance to the community, in reality, it is an inefficient system that ultimately begs the question: how effective is this governance mechanism? And does it truly achieve the level of decentralization that Uniswap so proudly touts?

In the context of crypto currencies and federal and state securities, whether the Uniswap platform is truly decentralized will turn on the Howey Test. The Howey Test established a test for determining if an investment contract, which is a security, exists. Under the Howey Test an investment contract exists where there is (1) an investment of money (2) in a common enterprise (3) with the expectation of profit (4) to be derived solely or primarily from the efforts of others.

Why is this important? Because if Uniswap is not sufficiently decentralized and passes the Howey Test, then the platform and its team will be participating in the unregistered sale of securities and will be subject to federal and state securities laws and regulatory scrutiny.

Uniswap Governance Protocol

Uniswap Labs released Uniswap's Governance Protocol in September 2020, when the team announced the launch of the UNI token. The UNI token is a governance token that enables holders of it to vote on changes to the Uniswap protocol and on how to allocate the funds in the governance treasury.

To participate in voting in Uniswap Governance you will need (1) UNI tokens; (2) ETH for transaction costs; and (3) a browser with Metamask installed.

The process begins in the "Governance Forum," where one can find proposals under current consideration, gather information about community sentiment, and engage with the Uniswap community. Once the proposal has passed through the proposal process and is ready for voting, the proposal will appear on the Uniswap voting dashboard.

There you can view all current and former Uniswap proposals. When a proposal reaches the voting stage, it represents real, executable code that will alter the functionality of Uniswap Governance or anything under its jurisdiction–if voted in favor of, of course.

UNI tokens are used as a voting mechanism. For UNI to be used as a vote, the owner must first delegate their votes to a particular address, which binds the voting power of the tokens to that address. This address can be the owner of the token themselves or a trusted party who they believe will vote in the best interest of the platform.

A democratic consensus, referred to as a "quorum," is determined by the percentage of UNI tokens in favor of, or against, a proposal. 1% of all UNI tokens must be cast in favor of a given proposal for the proposal to be submitted for a vote. And a quorum of 4% of all UNI must be cast in favor for that proposal to pass.

To date, it appears that only one governance proposal has been passed, as the only other two proposals to make it to the voting stage failed to meet the 4% quorum needed to pass a vote. The passed proposal established a Uniswap Grants Program (UGP), a program aimed at strengthening the development of the Uniswap ecosystem.

An illusion of decentralization?

A deeper analysis of Uniswap and its Governance Protocol yields a multitude of questions that suggest the platform may not be as decentralized as advertised. As an initial matter, the Uniswap team provided the community with 60% of the genesis supply of UNI tokens (1 billion) while giving themselves, investors, and advisers the remaining 40%.

Although the Uniswap team pledged not to participate in Governance decision-making for the "foreseeable future," there is no doubt that the team has a disproportionate amount of power in the early stages of governance.

Skepticism surrounding Uniswap's decentralized governance protocol is certainly warranted. Despite Uniswap Lab's vow not to participate in governance, the team could in theory use their UNI tokens to unilaterally make changes to the protocol.

Just as troubling, the team has claimed that the tokens allocated to them and Uniswap investors will be vested over a four-year period, yet the exact schedule has not been announced.

And, as opposed to the treasury tokens, which are locked up in smart contracts and will be released on a scheduled basis, it appears that the tokens allocated to the team and investors are fully liquid, as they are held at regular Ethereum addresses and have no restrictions on transfers. In addition to the vesting schedule being kept under wraps and the tokens being liquid, no one knows who controls the keys to these addresses.

It is clear Uniswap Labs has not been transparent with their UNI tokens, despite transparency being a key characteristic of DeFi and blockchain generally. So, is the Uniswap governance truly decentralized?

Moreover, as previously mentioned, Uniswap Labs has now released 3 versions of the Uniswap platform—the latest in May of 2021. The updated platform allows liquidity providers to set minimum and maximum prices on their portion of any given liquidity pool, otherwise known as "concentrated liquidity," and allows different pools to be created with different fees.

In essence, the Uniswap team made changes to the Uniswap platform unilaterally, without submitting these changes to the same governance process as any other proposal. The team simply kept the previous version of Uniswap running and dressed up Uniswap v3 as a brand-new platform.

How is this any different from a central party having authority and control over a network so as to dictate the future value of that network's native token? And what is to stop Uniswap community members from believing Uniswap Labs will continue to release updated versions of the platform, regardless of how the community votes to change the current protocol?

Another issue early on in the Uniswap Governance Protocol was the level of difficulty associated with achieving quorum. Uniswap's Governance Protocol requires 1% of the total UNI supply (10 million UNI) to vote in favor of a proposal simply to submit the proposal for a vote. Once the proposal is submitted for a vote, it requires a 4% quorum (40 million UNI) to vote in favor of it for that proposal to pass.

Reaching these totals is no easy task. And as more votes are spread across more delegates, the goal of achieving the required quorum becomes increasingly difficult. What is more, the issue of low voter turnout only adds to this difficulty. What results is a largely inefficient system where governance proposals seldom make it to the proposal stage; and, when they do get past the 1% threshold, rarely make it past the 4% quorum required to pass them.

On the other hand, several Ethereum addresses have accumulated a significant amount of UNI tokens by way of delegation. These addresses, also known as "whales," act as proxies for UNI holders who do not want to vote themselves but trust the given address to vote in the best interest of the protocol and Uniswap community.

These whales include several major platforms such as Compound, Gauntlet, and Dharma, and many prestigious Universities, including Harvard Law, UC Berkley, Stanford, and MIT. Each of these addresses holds more than 2.5 million UNI tokens, with the largest holding up to 15 million. Can the governance protocol be described as decentralized when only a few addresses can team up and unilaterally change the protocol or governance treasury?

Additionally, Uniswap Labs announced on Twitter that they have started restricting access to a number of tokens at app.uniswap.org, stating "[t]hese changes pertain to the interface at app.uniswap.org – the Protocol remains entirely autonomous, immutable, and permissionless." It is quite ironic that the Uniswap Labs team asserts that the Protocol remains autonomous, immutable, and permissionless in the same tweet they announced they will be restricting access to tokens.

How can the Uniswap team have control over the User Interface (UI) and access to tokens but claim that the platform is "entirely" decentralized? Is it even possible to have a decentralized network when the UI is controlled by a central authority?

Aside from the Governance Protocol, an argument could be made that Uniswap is not decentralized based on the infamous "DAO Report" released by the SEC in 2017. In that case, the SEC argued that holders of the DAO token had to rely on the managerial efforts of the founding team because the team led investors to reasonably expect they would provide such efforts through their conduct and marketing materials.

The same reasoning can be applied here. UNI token holders may reasonably expect that the Uniswap Labs team, led by founder Hayden Adams, will undertake the managerial efforts to drive the value of the token.

Through Uniswap Labs' and Hayden Adams' tweets, vision, and public engagements, it is not a stretch to say the Uniswap community reasonably expects Uniswap Labs and Hayden Adams to continue their managerial efforts.

One example is Mr. Adams' recent announcement that he is in talks with PayPal to roll out a joint venture together. Mr. Adams has made himself the face of the company, and community members could reasonably expect his managerial efforts to continue driving the success of the platform and the UNI token.

Conclusion

Whatever our concerns may be, it is clear that Uniswap Labs and its legal team do not share the same sentiment. Indeed, centralized exchanges require platforms to provide written legal opinions that they are sufficiently decentralized to faily he before any particular token can be traded on their exchange.

Who exactly concluded that the Uniswap platform is sufficiently decentralized?

And what is their reasoning behind that conclusion?

An argument could be made either way. Further, if Uniswap constitutes an investment contract, then the platform is engaging in the unregistered sale of securities and will be subject to federal and state securities laws.

The only thing that is clear is that the answer is unclear.

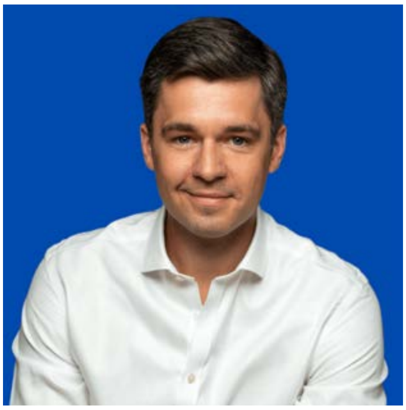
Contacts

Dilendorf Law Firm, PLLC

E-mail: md@dilendorf.com

Phone: +1-212-457-9797

Address: Dilendorf Law Firm
4 World Trade Center Suite 2979
New York, NY 10006



Max Dilendorf

Partner

E-mail: md@dilendorf.com

@dilendorf_law