

# OASIS PRO

## How Tokenized Securities are Evolving the Financial Industry

A three-part series explaining how security tokens work and the steps that financial institutions should take to capitalize on the benefits.



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# PART 1

## Digitizing Legacy Financial Systems

In this first article, we look at how blockchain technology is evolving securities.

Tokenized securities bring novel features to the market's legacy securities framework. They can benefit both issuers and investors when forming, issuing, and managing assets to create more secure, transparent, and accessible markets.

Banks and financial institutions also stand to gain from streamlining processes for issuance, payment, and settlement operations. Increased efficiency in secondary trading is another advantage. Furthermore, tokenization may enhance liquidity in previously illiquid markets by enabling more investors to participate via fractionalized offerings.



## An Innovative Method For Managing Securities

Tokenized securities are digital tokens that prove ownership in a real-world asset, such as stocks, bonds, real estate, or other financial instruments. This involves encoding the terms of the security, including ownership rights, transferability, and other relevant information, into a smart contract deployed on a blockchain network.

Once the information is on a blockchain network, events such as distributions or corporate actions can be executed automatically, reducing or even eliminating the need for intermediaries. Above all, tokenized securities issued on a blockchain can provide enhanced security and transparency for investors based on a blockchain's decentralized, tamper-proof, and transparent protocols.

Built-in compliance and operational functions are also appealing features at a time when firms are transitioning to T+1 and striving towards same day or even instantaneous settlement. The transaction of a digital asset is recorded on the blockchain, and the investor's ownership is reflected almost instantaneously in the ledger propagated across the network, acting as a real-time, single source of truth. Additional logic, including transfer restrictions, can also be included in the smart contract, creating opportunities for automation when managing and servicing the asset.

## Don't Confuse Tokenized Securities With Cryptocurrencies

Tokenized securities are sometimes confused with cryptocurrencies because of their common dependency on blockchain technology, but they are entirely different. A “cryptocurrency” is a blockchain-native token that is used to pay for transaction fees and acts as an economic security incentive within the network. Tokenized securities, however, are created by an institution as a blockchain-based representation of real-world assets or securities.

While cryptocurrencies offer an alternative to traditional financial institutions and instruments, digitized or tokenized securities are designed to be integrated into the existing financial system and aligned with regulatory frameworks that prevent fraud and protect investors.

## Benefitting From Digitization

While tokenized securities may someday solve for inefficiencies in large, liquid, public markets such as equities or treasuries, private markets appear to be the most fertile field for innovation today. At the beginning of 2021, the private market was estimated to be worth over \$7.3 trillion<sup>1</sup>, and yet many investors remain underweight private assets due to a variety of factors, including lack of awareness, high minimum investments, long lockup periods, and cumbersome subscription processes.

Digitizing private offerings such as private equity, real estate, and infrastructure could help overcome these drawbacks and inefficiencies, increasing investor exposure to growth and income opportunities.

Issuing institutions also stand to benefit as these improvements open the door to a larger investor base and increased revenue opportunities. Investors and issuers also benefit from time and cost savings achieved through reduced friction and more efficient processes, both upstream, when a token is issued, and downstream, servicing a token.



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<sup>1</sup> <https://www.moonfare.com/pe-masterclass/private-equity-marketsize#:~:text=According%20to%20Preqin%20%2D%20a%20research,market%20has%20surpassed%20%247.3%20trillion.>

## Let's look at this in a bit more detail.

For example, calculations on the blockchain serve as the single source of truth, removing the need for multiple reconciliations. Updates can be fed automatically via application programming interfaces (APIs) directly to a financial institution's system to feed downstream processing.

For the issuer, this could lower the cost of bringing an offering to the market and maintaining it. In return, the investor potentially benefits from higher yields or possibly higher returns. Blockchain also provides institutions with the opportunity to retire legacy systems whose technology can be expensive to support and whose languages are dated.

Accelerating the settlement process is another massive opportunity. Traditionally, the settlement of an investment transaction is a three-step process. First, the trade where the buy and sell order amounts are matched. Next, comes the clearing process when the two so-called clearing members agree to exchange cash, thereby creating claims on each other. The last step in the transaction—settlement—has occurred when cash is wired in exchange for security transfer via DTC. The standard settlement period for most securities is two days, although some settlements are much longer.

With digitized securities, settlement becomes instantaneous, or "atomic." In this delivery-versus payment (DVP) arrangement, the payment and transfer of ownership for a security occur at the same time, eliminating the clearing step. The smart contract facilitates the exchange of stablecoins (a cryptocurrency which is pegged to a currency) versus securities directly into each party's wallet. If that doesn't occur, the transaction will reverse itself. This atomic settlement allows both parties to return cash and investments to work faster than before.



Further streamlining occurs with tokenized securities that make regular payments to an investor's digital wallet. The tokenized security has built-in information to process the payments so that income is paid out correctly and almost immediately with both sides having an immutable record (the blockchain) that the funds were sent. This improves on the existing time-consuming process where investors receive coupons or dividend payments only after third-party providers and back-office servicing have doublechecked information such as wire instructions, mailing address, and primary owner on the cap table.



## Revolutionary Regulation

By eliminating room for human error, blockchain enables smoother fund and securities transfers and more efficient compliance monitoring, helping to prevent fraud, money laundering, and other crimes. This not only benefits investors but also broker-dealers carrying out Know Your Customer / Anti Money Laundering (KYC/AML) procedures.

With digital wallets and smart contracts, specific information about a client's eligibility, security-specific transfer, and other regulatory restrictions can be coded in. For investors this also means that timeconsuming forms and applications can be completed just once and appropriately updated.

Alternative Trading Systems (ATS) will likely play a leading role in creating liquidity in tokenized securities. These platforms are trading venues that can be regulated and operated by SEC-registered broker-dealers and may offer a customizable trading solution for digital assets deemed to be securities.

ATS are not categorized as self-regulatory organizations (SRO) like national exchanges and cannot establish their own rules of conduct or discipline subscribers, as exchanges do for their members. Nonetheless, ATS play an important role, alongside the exchanges, in creating transparency, efficiencies, and liquidity in tokenized security markets. Additionally, they are subject to regulatory oversight by FINRA and the SEC and thus are well positioned for the SEC to input a stronger framework for regulated trading of digital securities.



## The Shift is Imminent

The popularity of tokenized securities is growing with the number of use cases. The largest volumes are on platforms such as Onyx by J.P. Morgan,<sup>2</sup> where institutions use blockchain for repurchase agreements, gaining instant settlement, intra-day liquidity, and streamlined processes. Tokenized funds are emerging globally as well, as sponsors fractionalize interests to appeal to a broader base of investors. In addition, there have been large bond offerings out of Europe, where global institutions have digitized to make bond issuance faster and simpler.

Both institutions and investors are beginning to experience the benefits of tokenization. The legacy systems and processes are ripe for updating and blockchain is the technology that can finally bring the financial industry into the new digital age.

In the next article, we will look at the technology, processes and people needed to take advantage of tokenized securities, including governance structures, network security mechanisms, and smart contract standards.



<sup>2</sup> <https://www.jpmorgan.com/onyx/index>

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