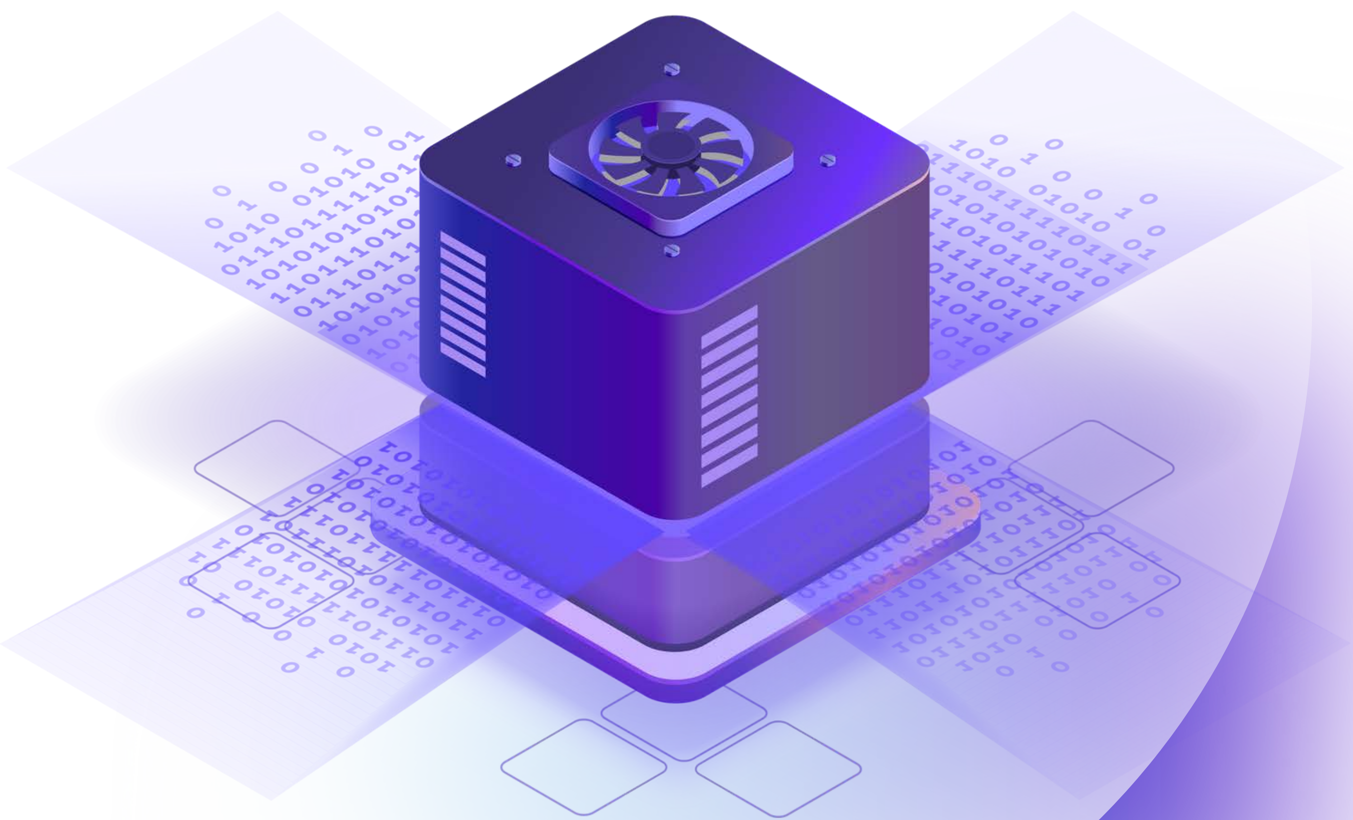
OASIS PRO

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 3

Unlocking the Potential of Security Tokens

In the third and final part of our series about how tokenized securities are evolving the financial industry, we look at the steps that institutions and investors can take to unlock the potential of security tokens.

The digital evolution of financial markets is much more than a theory or forecast for the next decade. The most innovative firms are already executing their transition plans to get a head start on their competitors and unlock the benefits of asset tokenization. For example, Onyx by J.P. Morgan promises 24/7 trading of corporate treasuries, and large private equity firms such as KKR are also tokenizing funds.

In this article, we list best practices that modern asset managers can apply when implementing a digital transition strategy and the advantages of this approach.

Transitioning to a Decentralized Market

Digitizing the private market security issuance and management process, supported by blockchain technology, unlocks an array of benefits for issuers and investors. These include enhanced liquidity management, programmable disbursements, and near instantaneous settlement.

Tokenized securities, for example, are expected to capture $5 trillion of market capitalization by 2026.[1] This expansion is driven by the promise of enhanced efficiencies in operation, emphasis on peer-to-peer trading, and the emergence of new financial constructs led by decentralized financial platforms.

By facilitating global access to collateral pools, asset tokenization can support real-time price valuations and reduce the need for intermediaries. The ability of smart contracts to automatically execute workflows, such as near-instantaneous trade settlements combined with real-time valuation enable rapid collateral liquidation and minimize the risk of full default. The immutable nature of blockchain ensures that all recorded transactions are tamper-resistant, enhancing trust and confidence throughout the collateral management process.

[1] https://www.statestreet.com/us/en/wealth-manager/insights/security-tokens-new-market-paradigm-europe

Defining The Advantages

Private equity issuers and real estate funds are already taking advantage of greater access to liquidity offered by tokenization. By further enabling secondary markets, investors in these funds can also access higher liquidity and potentially face less of a discount should they divest early. Issuers also pay less fees to intermediaries and gain access to a broader investor base since tokenization also allows for the fractionalization of fund shares.

Issuers can also minimize the risk of default or mismanagement using smart contracts that automatically enforce collateral requirements and release or liquidate assets once conditions are met. Smart contracts can also significantly reduce counterparty risk in collateral transactions.

For difficult or irregularly traded assets such as mortgage-backed securities, the transition to blockchain trading opens the door to instantaneous settlement and decreased risk. As these unconventional trades occur away from the pools (typically during times of stress and illiquidity), the shortening of the settlement cycle boosts confidence and liquidity of market participants by increasing trading capabilities and freeing capital.[2]

Instituting blockchain settlement also strengthens delivery-versus-payment (DVP) and delivery-versusfree (DVF) processes without an intermediary or clearing agent. Higher success rates can help all counterparties reduce fail charges, which even today represent a multi-billion dollar issue.[2,3]

2 https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr933.pdf
3 https://www.sifma.org/wp-content/uploads/2017/06/TMPG_Agency-fails-charge-trading-practice_04-23-18.pdf
4 https://libertystreeteconomics.newyorkfed.org/2023/04/the-2022-spike-in-corporate-security-settlement-fails/

Modernizing Financial Transactions

To achieve these benefits, firms should familiarize themselves with the roles of different stakeholders in the world of digital securities.

The **issuer** is the initial owner of the contract that is published to the ledger and is the beneficiary of funds raised from the security sale. Typically, they have access to administrative functions such as minting or burning tokens, forcing transfers, and upgrading contracts.

The **issuer** works with the contract developer and transfer agent to facilitate the development and execution of the security issuance process.

The **contract developer** writes the code that executes the underlying logic of the smart contract. The developer/development team has control over the business logic that is encoded into the contract, so it is key that there are oversight policies in place. Development may be handled by the issuing organization, or the issuer may contract a third-party to assist them through the development and deployment process. Either way, it is imperative that contracts are audited by a capable internal team or third party to ensure they function as designed.

The **transfer agent (TA)** maintains transparent records of all transactions. The TA streamlines the tracking and management of the digital assets, with a comprehensive, real-time view of the cap table, both off- and on-chain. As a representative of the issuer, in most cases the TA is responsible for compliance and calculating the payouts/dividends associated with the security.

Instituting Best Practices

All firms engaged with third parties such as tokenization platforms, exchanges, and ATS must adapt to comply with the Third-Party Risk Management (TPRM) guidelines issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and The Federal Deposit Insurance Corporation.[5]

This guidance harmonizes industry best practices for dealing with third parties, highlighting oversight responsibilities, and defining risk management vectors.[6] Any innovative solution that uses a blockchain almost certainly exhibits the three characteristics of "critical activities" which the guidance calls out for more rigorous oversight.

By choosing best-of-breed technology and service partners, alongside the implementation of TPRM frameworks, financial institutions will find themselves in the envious position of providing premier, cutting-edge products without falling foul of regulations.

Taking The Steps to Capitalize on Tokenization

As this series of articles shows, issuers and investors stand to make significant gains by adopting a digital securities strategy. As well as simplifying and automating back-office functions, asset tokenization facilitates faster capital deployment through instantaneous and intra-day settlement, advanced collateral management, novel liquidity in private assets, and overall added efficiencies and cost reductions. These functions have the potential to unlock significant savings in third party fees and enable managers to set themselves apart from their competition.

5 https://www.fdic.gov/news/financial-institution-letters/2023/fil23029.html
6 https://www.capco.com/Intelligence/Capco-Intelligence/Interagency-Guidance-on-Third-Party-Risk-Management

Find out more about how to take full advantage of digital securities and tokenization:

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