
This webinar will begin shortly.
FIA

Tokenization in 2025

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Presentation prepared by K&L GATES

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Roadmap

- Defining “Tokenization” and “Tokenized Assets”
- Hurdles to Adoption
- Benefits of Tokenization and Use Cases
- Existing Legal and Regulatory Framework
- Industry Initiatives
- What’s Next

What is “Tokenization”?

Tokenization Defined

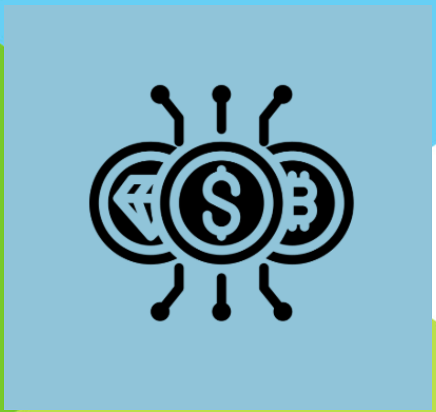
- FIA Tokenization Working Group: Asset tokenization involves digital tokens that represent tangible or intangible assets, such as stocks, bonds, cash, or securities, and creating a record of ownership for such assets on blockchains.

- ISDA: "tokenization" broadly refers to a technological and legal process of attaching enforceable rights to entries in a DLT-based system.
  - Tokenization is <u>not</u> a single, uniform mechanism

- GMAC definition of "Tokenized Derivative": a "digital twin" token that represents an underlying derivative instrument issued and recorded on a different platform, where such representation itself satisfies the definition of a derivative under relevant law.

Characteristics of Tokenized Assets

- Who retains control of the tokenized asset, including the ability to update the underlying DLT record?
- How is transfer of the tokenized asset effectuated?
  - Option 1: updating the token balances on the DLT record
  - Option 2: transferring the token from one wallet to another
- Is the token itself an asset, or merely evidence of ownership (i.e., does the token have value, or is it a form of recordkeeping?)
- What’s not a tokenized asset?
  - BTC, ETH, other “cryptocurrencies”



Distributed Ledger/Blockchain

- What is Distributed Ledger / Blockchain?
  - "A distributed ledger is a database that is ***consensually shared and synchronized*** across network spread across multiple sites, institutions or geographies. It allows transactions to have public 'witnesses,' thereby making a cyberattack more difficult. The participant at each node of the network can access the recordings shared across that network and can own an identical copy of it. Further, any changes or additions made to the ledger are reflected and copied to all participants in a matter of seconds or minutes. Underlying the distributed ledger technology is the blockchain, which is the technology that underlies bitcoin." *See* Investopedia Definition of "Distributed Ledger"
- Core principles of trust, verifiability, immutability and transparency
- Distributed ledger as a technology has multiple uses for multiple industries, including the Financial Services industry
- Tokenization is just one aspect of the uses for blockchain

Industry Lingo

RWA: Real-World Asset (i.e., bank deposits, real estate, Treasuries)

TVL: Total Value Locked (i.e., the U.S. dollar value of assets that are locked on a blockchain)

DLT: Distributed Ledger Technology

Oracle: A third-party that connects a blockchain and an external system/the trusted information based on off-chain data, allowing smart contracts to execute upon specific events

Background

New Challenges for the Financial Services Industry

- Ongoing regulatory complexity and a dynamic regulatory environment in US and abroad
- Significant fee compression and higher costs of doing business
- A changing competitive landscape and rising competition, including from non-traditional competitors like FinTech companies
- Volatile market returns
- A greater need for more efficient and simplified operating models
- Changing demographics, customer dynamics, and customer expectations
- Data management
- Talent management
- And, of course…rapid technology changes

Transformation of Business Models to Address These Challenges

- Consolidating via reorganizations and mergers
- Rationalizing their product line ups
- Expanding into new business areas
- Partnering with peer firms, service providers, and competitors (including FinTechs)
- Creating new, more personalized and more mobile friendly client tools and experiences
- Leveraging automation to enhance efficiency and productivity

Emerging Technologies

Emerging technologies—such as blockchain—are playing a critical role in:

- enabling business transformation;
- driving opportunities for efficiencies across front-, middle- and back-office activities; and
- driving opportunities for value creation.

Blockchain Adoption

Business Opportunities

- Reduce settlement and clearance times and shorten the trading cycle
- Improve liquidity
- Open new markets
- Custody
- Linked transfer agency networks

Operational Efficiencies

- Lower intermediary costs by bypassing traditional intermediaries
- Increase automation of business logic and workflows and
- Reduce the need for reconciliation

Potential for Risk Reduction

- Enable simpler regulatory reporting and provide an immutable audit trail
- Enable faster risk management

Hurdles to Adoption

Initial Headwinds

- Blockchain is still a relatively new technology, and not surprisingly, regulatory uncertainty, legal risks, and lack of trust among users are hurdles that top many polls reported in the media.
- The creation of new business and governance models and best practices will require industry-wide coordination.
- But, there is a reluctance to change established business processes.
- Significant investment in existing technology systems is required.
- Integration with legacy systems could be challenging.
- Connectivity among separate blockchain networks presents security concerns.
- Exception processing is challenging in a blockchain environment.
- Return on investment is uncertain.

Operational Challenges

- Risk of coding errors in smart contracts
- Network security risks
- Integration with legacy systems
- Connectivity among separate blockchain networks presents security concerns
- Exception processing is challenging in a blockchain environment

Legal and Regulatory Obstacles

- Use of open blockchain architecture presents challenges with:
  - Recordkeeping and data storage (including ownership of records)
  - Privacy and confidentiality
  - Lack of control over change management and technical issues in underlying technology
- Legal status of decentralized autonomous organizations
- Risk disclosure

Benefits of Tokenization

Predictions for 2030

- 5-10% of all assets will be digital
- The market for tokenized assets could reach $10-16 trillion

*Source: Chainlink, Beyond Token Issuance (Apr. 2024).

Benefits

- Efficiency
- Transparency
- Enhanced liquidity
- Reduction or elimination of storage, transportation, and divisibility obligations related to a physical commodity (but, ETFs may already solve for these issues)
- Competitive advantage

Speed of DLT

T+0

- Simultaneous execution and settlement
- Continuous 24/7 trading
- Automation of complex rules into the tokens, reducing settlement times and other operational issues

Fractionalization

- Makes certain assets more affordable
- Allows multiple persons to invest in a single asset (e.g., NFTs, art, and wine), making investments more attainable
- Price discovery for illiquid assets
- Broader access to liquidity

Use Cases

Tokenization in 2025

- Broadridge intraday repo transaction between Natixis and SocGen
- JPM Kinexys (formerly Onyx) blockchain platform
- DTCC Project Ion equities settlement
- European Investment Bank tokenized bond issuances
- HQLA Digital Collateral Registry
- Lugano, Switzerland municipal digital bond

"ETFs are step one in the technological revolution in the financial markets. Step two is going to be the tokenization of every financial asset."

Larry Fink,
Chairman and CEO of BlackRock

WisdomTree

- New Mutual Fund Complex
  - First registered investment company trust to put transfer agency services on the Blockchain
  - Expecting to offer peer-to-peer “tokenized” transfers of shares in the future on proprietary trading application
  - Critical to have regulatory, blockchain, digital asset and crypto knowledge and experience working together
- Other issuers are beginning to engage in similar initiatives.

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Various Blockchain Use Cases

- Transfer agents in registered investment company and public company space
- Proxy voting: Allows companies to know in real time who has voted; prevents a person from voting twice
- Securities lending: The escrow of digital assets held on a ledger could reduce risk in collateral management
- Peer-to-peer transfers of fund interests
- Sharing of information for regulatory purposes AML/KYC: Gain efficiencies by allowing one organization's vetting and verification of a client to be accessed by another organization, without starting the process over

ISDA: CSA Provisions for Tokenized Variation Margin

- In May 2024, ISDA published model provisions for Credit Support Annexes (CSAs) for variation margin for parties that agree to transfer tokenized securities or stablecoin that utilize DLT, or “Tokenized Collateral”
- Model Provisions:
  - Allow for the designation of Tokenized Collateral as variation margin
  - Update the definition of Local Business Day
- Guidance Note:
  - Enforceability opinion
  - Issues to analyze in the opinion

Existing Legal and Regulatory Framework

CFTC

- The CEA and CFTC regulations allow for non-cash assets as collateral for both cleared and uncleared derivatives, subject to certain conditions designed to mitigate credit, market and liquidity risks
  - Cleared Futures and Swaps: CFTC Regulation 39.13(g)(10)
  - Uncleared Swaps: CFTC Regulation 23.156(a)(1)(ii)-(x)
- Generally speaking, the CFTC holds itself out as "technology neutral"
  - Recordkeeping, 82 Fed. Reg. 24,479, 24,483 (May 30, 2017) ("As noted throughout this adopting release the Commission believes that the amendments to §1.31 are intended to be technology neutral and therefore the Commission is not requiring or endorsing any type of record retention system or technology.")
  - Statement of Chairman Gary Gensler, Core Principles and Other Requirements for Swap Execution Facilities,78 Fed. Reg. 33,476, 33,603 (Jun. 4, 2013) ("Thus, today's rule is technology neutral.")

CFTC

- Arguably, the existing CFTC regulatory framework already accounts for tokenized collateral, and no new rules or guidance are needed
- However, FCMs and DCOs may need to consider updates to their policies and procedures or perform analyses related to:
  - Customer protection: holding funds in a way that minimizes risk of loss; withdrawal upon demand
    - CFTC Regulation 39.13(g)(10): a DCO must hold clearing member and customer funds in a manner which minimizes the risk of loss or of delay in the DCO's access to such funds
    - CFTC Regulation 1.20(h): customer funds deposited with a bank or trust company must be immediately available for withdrawal upon demand of the FCM or DCO
  - Due diligence related to new technology and information security
    - CFTC Regulation 39.18
  - Demonstration that the tokenized collateral has "minimal credit, market, and liquidity risks"
    - CFTC Regulation 39.13(g)(10)

SEC Jurisdiction Over Tokens

- SEC has jurisdiction over tokens that are "Securities" under the U.S. Federal Securities Laws
- Whether token is a "security" depends on the facts and circumstances of the offer and sale of the particular asset.
- According to the seminal *Howey* test, an asset is an "investment contract" and thus a security if it involves "an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."
    - Thus, whether a given token is a security depends on the structure of the offered asset and the nature of the transaction (including public representations) rather than on the label applied to the asset.
- SEC issued framework for determining when a Digital Asset is an Investment Contract in 2019
- SEC Crypto 2.0 – Working Group announced this week with goal of bringing regulatory clarity to digital assets space

FinCEN and State Law

- Custody of tokenized assets may trigger money transmitter licensing requirements at both the state and federal level
- In some states, a separate licensing regime exists that is specific to digital assets, which may also be implicated by custodying tokenized assets (e.g., New York's BitLicense)

NYDFS

"Virtual Currency Business Activity"

(q) *virtual currency business activity* means the conduct of any one of the following types of activities involving New York or a New York resident:

(1) receiving virtual currency for transmission or transmitting virtual currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of virtual currency;

(2) storing, holding, or maintaining custody or control of virtual currency on behalf of others;

(3) buying and selling virtual currency as a customer business;

(4) performing exchange services as a customer business; or

(5) controlling, administering, or issuing a virtual currency.

FinCEN and State Law

- Some states have carveouts from money transmitter licensing for CFTC registrants, but this analysis needs to be carried out on a state-by-state basis

FinCEN and State Law

- Practice tip: ensure that your CFTC, SEC, and payments / money transmission lawyers are working together when advising on these matters

Industry Initiatives

CFTC Global Markets Advisory Committee

- GMAC Digital Asset Markets Subcommittee
  - *Recommendations to Expand Use of Non-Cash Collateral Through Use of DLT*
    - Intended to facilitate the use of tokenization for assets already eligible to serve as regulatory margin under the CEA and CFTC regulations
    - Describes benefits of DLT / tokenization, which can solve some operational problems related to traditional non-cash collateral
    - Advocates for no new rules or guidance from CFTC; registrants can rely on existing policies and procedures to address use of new technology and infrastructure
    - Approved November 21, 2024
  - *Digital Assets Classification Approach and Taxonomy*
    - Intended to apply across jurisdictions and to facilitate consistent drafting of future laws, regulations and policies
    - Terminology is expected to evolve (and be updated) as the digital asset ecosystem evolves
    - Approved March 6, 2024

FIA Tokenization Working Group

- FCM and DCO acceptance of tokenized collateral
- Regulatory implications related to tokenization
- Identifying specific regulations where a potential need for CFTC guidance could arise

Securities Industry Initiatives

- SIFMA – Policy Priority - Digitization
  - SIFMA is working with member working groups to determine and identify the activities, requirements, and considerations for market participants engaging in operationalizing security tokens.

What’s Next?

Implementing Tokenization

- What is the use case?
- What blockchain will be used to issue tokens?
- How will custody be addressed?
- Is an oracle necessary if smart contracts are being employed?
- How will AML/KYC be performed if required?
- Does the token initiative fit within an existing legal or regulatory framework? Is that framework subject to change under the new administration?

Biographies

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Cheryl Isaac is a partner and a member of the Asset Management and Investment Funds practice, where she concentrates on derivatives and commodities law. Cheryl advises a broad range of derivatives market participants—energy and commodity traders, financial institutions, brokers, asset managers, and derivatives exchanges, among others—on legal and regulatory matters under the Commodity Exchange Act, the Dodd-Frank Act, and related US Commodity Futures Trading Commission (CFTC), and National Futures Association (NFA) rules and regulations. She works with clients to apply for registration with the CFTC and NFA, or to determine if there are any applicable exemptions from registration. She also advises clients on security-based swaps and applicable US Securities and Exchange Commission (SEC) regulations

In addition to traditional finance, she also counsels derivatives and commodities market participants on a variety of emerging asset classes with evolving regulatory frameworks, including digital assets, decentralized finance (DeFi), and voluntary carbon credits.

Cheryl has significant experience negotiating bespoke derivatives transactions in a variety of asset classes (interest rates, FX, digital assets, and commodities), including ISDA Master Agreements and related documentation.

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Sarah Riddell is a partner and a member of the firm's Asset Management and Investment Funds practice. As a former regulator, Sarah has insight that enables her to be a trusted advisor to clients. She frequently speaks at conferences and engages in thought leadership on emerging issues important to the derivatives industry.

Sarah advises a broad range of market participants on regulatory matters. She assists US and international futures and swap exchanges, clearing houses, and financial institutions on Commodity Futures Trading Commission (CFTC) registration, compliance, and cross-border issues. She also advises exchange-traded fund issuers, private fund managers, futures commission merchants and swap dealers with CFTC and National Futures Association (NFA) with becoming registered with the CFTC, developing compliance programs, and successfully undergoing regulatory examinations. Sarah also works with trade associations, particularly when the CFTC and Securities and Exchange Commission propose new or amended regulations.

Sarah advises a range of clients on regulatory matters involving digital assets, including helping institutional investors conduct due diligence on investments, analyzing the legal and regulatory status of a digital asset, and advising issuers on state law and regulation, including the applicability of the New York State Department of Financial Services (NYDFS) BitLicense regulation and federal and state laws and regulations.

Biographies (cont.)

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Richard's practice includes providing counsel to financial institutions on a broad array of corporate, regulatory, transactional, and operational matters, including: formation, registration, and ongoing operations of registered investment companies (including mutual funds and exchange traded funds), bank collective investment trusts, investment advisers and broker-dealers; reorganization transactions; mergers and acquisitions; negotiation of service provider agreements; public and private offerings of securities; holding company formations; and new product offerings. Additionally, Richard frequently advises ETFs, investment advisers, broker-dealers, and other financial institutions regarding the US federal securities law implications of their cryptocurrency, digital assets, and blockchain related activities.

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