Disrupting Financial Markets (4) - Efficiency gains

Graham Rodford

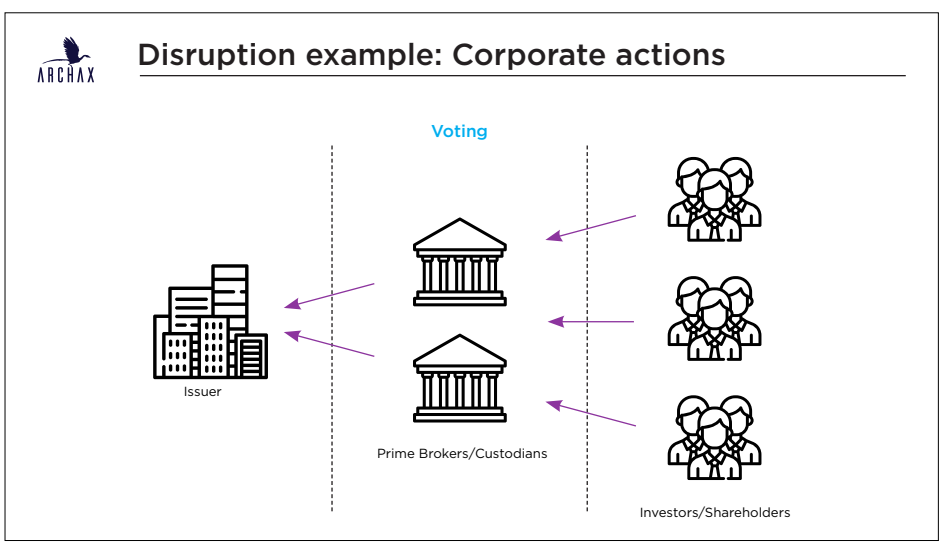
In this article, the fourth in our series on "Disrupting Financial Markets", we drill down into a couple of examples of specific operational advantages beyond those already discussed.

There are others, but these are our two current favourites.

Corporate actions

A corporate action can be thought of as anything where there tends to be a feedback loop between the issuer and its investors. Whether it is voting, paying a dividend or interest on a debt, they all present their own challenges.

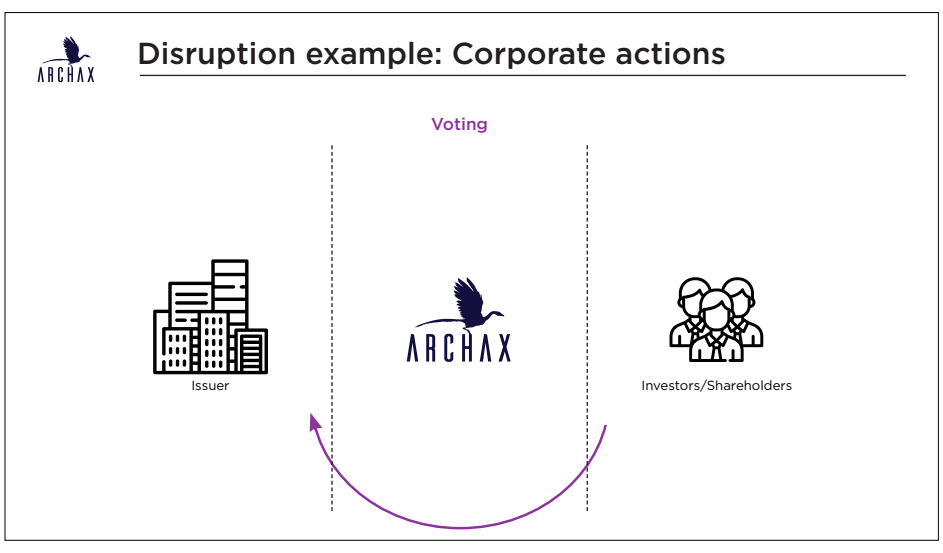
If we look at voting as an example, issuers will send out communications to their shareholders, often via prime brokers or custodians, and when the shareholders have decided the way they want to vote, they pass their communications back to the prime brokers, etc. who pass it on to the issuer.



There are two real issues that exist here. Firstly, when the investor votes, there is no way of them knowing for sure that the prime broker or custodian has actually placed their vote correctly with the issuer. Theoretically, because they tend to be regulated counterparties, the investor can have some comfort that that was the case, but there is no way of knowing for sure.

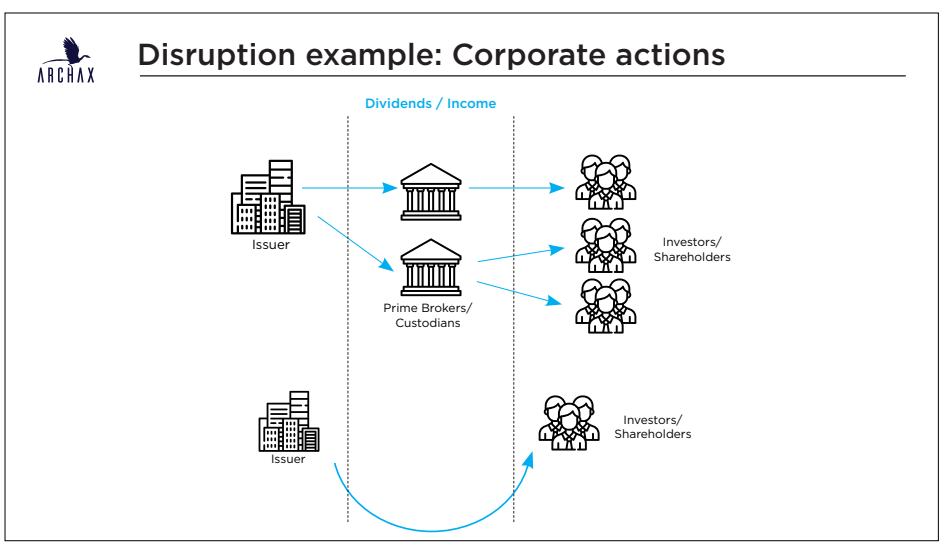
Secondly, an issuer will often give a deadline along with any sort of corporate action, and prime brokers and custodians need to be able to relay the shareholders' votes onto the issuer by this date. Thus, by having this extra level in the middle, the prime brokers or custodians have to impose their own deadline to make sure that they meet the issuer's deadline, which results in slippage to investors. This isn't necessarily a problem with voting for the most part, but when it comes to event-driven managers, the increase of time between deadlines is a problem, since portfolio managers like to take decisions as close to the wire as possible.

One way this can be improved is if the investor can communicate straight to the issuer, which can be achieved nicely through blockchain.



Notifications of voting can go straight out to the investor and their elections can come straight back into the issuer, rather than using the custodian in the middle. The result is that investors can go right until the deadline with their votes.

On the distribution side, issuers need to pay out dividends or income to investors and shareholders. At the moment, this goes through the prime broker or custodian again, who need to pay them onwards to the investors. This can introduce delays as the money is being transferred across, as it can sit in the custodian before it's allocated out.



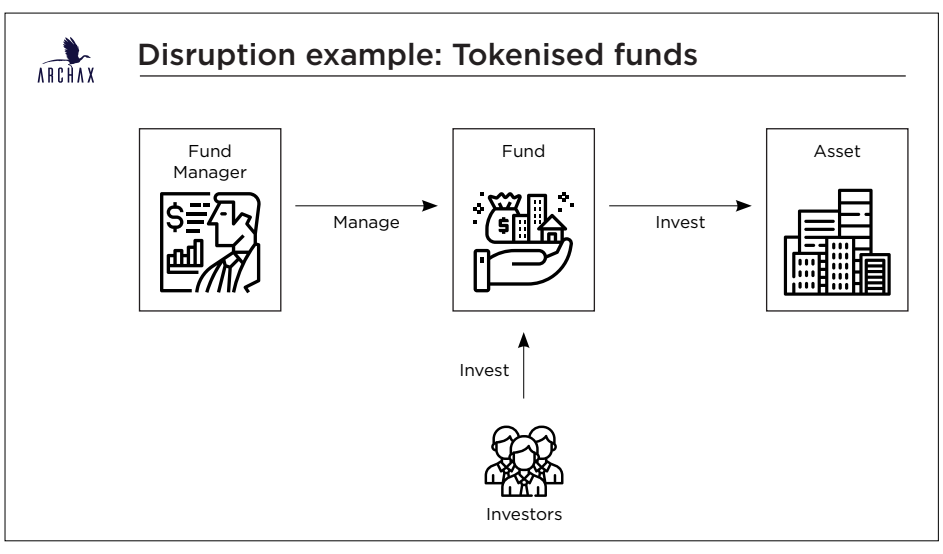
In the future, as with voting, a direct relationship between the issuer and shareholders means that when the issuer makes a payment, it is sent straight to them across a blockchain without going through the intermediaries. It is already possible to do this with assets such as scrip dividends, but when we start to see an increased use of stable coins or digital currencies, we believe we will also see dividend payments being paid directly to shareholders too, rather than relying on prime brokers and custodians having to gather bank documents and make fiat payments that way.

As you can see, distributed ledger technology has the ability to greatly improve the flows of information between issuer and investor.

Tokenised funds

One of the most exciting opportunities for existing capital markets is presented by the tokenised fund space. For the most part, we have met with asset managers with lower AUM looking to create an innovative fund product, but the benefits should be explored by all asset managers.

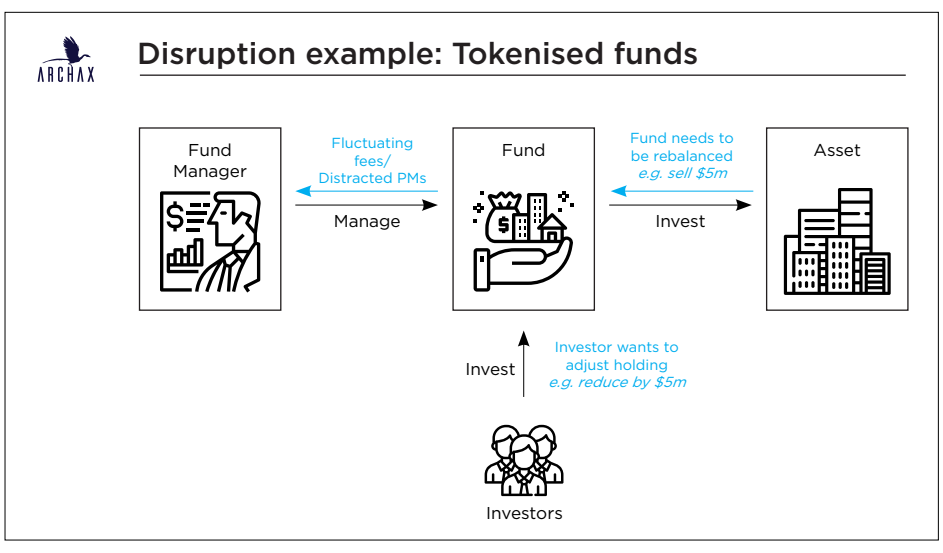
In our second article in this series on market infrastructure and the third article on the tokenisation roadmap, we explored benefits for issuers which are also relevant to funds, but there are other advantages worth exploring too.



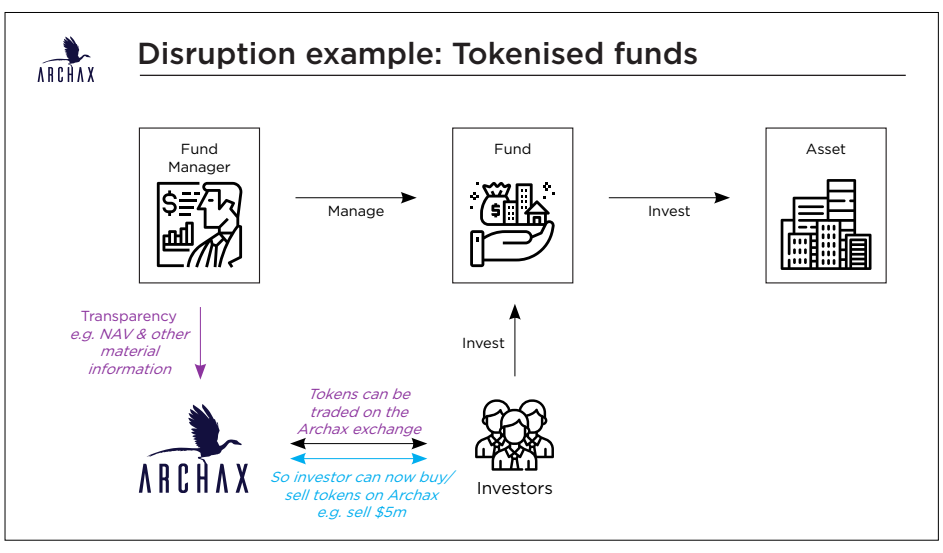
As shown in the above diagram, currently investors invest into a fund that in turn invests into underlying assets. That fund is managed by a fund manager, and if an investor wants to redeem from a fund and they submit a redemption request, for say $5m from a $100m fund, the manager then has two problems.

Firstly, they must raise enough cash to be able to satisfy this redemption. If they do not have spare cash in the portfolio, the only way they can do this is to sell some of the assets that are underlying the fund. So they must find assets that they are able to sell that can be used to process the redemption request. In a fund where the assets are large and illiquid, they may need to be selling an entire asset rather than being able to pro-rata sell the constituent parts of the portfolio.

Secondly, it means that the fund manager has fluctuating fees as their AUM is changing. This fund is now a $95m fund, so not only has the investment manager been distracted from running the portfolio, but they also now receive lower fees.



Instead of this, imagine that a fund manager tokenised their fund and made these representations of ownership tradeable on a secondary market like Archax.



With sufficient liquidity and appropriate transparency, there can be effective price discovery on a venue like Archax. We would need to make sure that the fund manager produces information, such as a NAV or other material information that might influence the price, so that investors can make informed decisions. If we can achieve this liquidity and price discovery, then rather than redeem, investors can now sell on the exchange.

Willing purchasers can buy straight off the secondary market rather than go through the whole subscription cycle. And investors no longer have to wait for the redemption cycle, they can receive their funds in a quicker fashion.

So now you've got a situation where, in that same example, the investment manager is still managing the $100m, as the liquid secondary market is able to satisfy the investors' need to sell. The portfolio manager is no longer distracted, and they have a permanent source of capital on which they will receive consistent fees.

In our next and final article in this series, we will explore what everyone means when they talk of the 'democratisation of finance' and how Archax plans to be a part of it.