

# ASSET MANAGEMENT **INSIGHTS**

INSIGHTS FROM THE BDO FINANCIAL SERVICES PRACTICE

## **BLOCKCHAIN: FORGING THE FUTURE OF ASSET MANAGEMENT**

By Keith McGowan, Asset Management Industry Co-Leader, Assurance Partner and Ignacio Griego, Assurance Partner

Distributed ledger technology (DLT), such as blockchain, could be a revolutionary tool for the asset management industry. It has the potential to reduce costs, increase operational efficiency, improve transparency and facilitate a range of innovative investments. However, major players in the industry have been slow to adopt this technology solution. According to [BDO's 2020 Financial Services Digital Transformation Survey](#), only one-third (33%) of asset management executives at middle market organizations say they are already deploying DLT, and nearly half (48%) are still considering it. So, it's important to identify how asset managers can use this technology to capture new opportunities and stave off competitive disruption.

Here are several key areas where the application of blockchain can revolutionize the future of asset management by improving speed, efficiency and security, while also creating new vehicles for investment.

### **BDO'S ASSET MANAGEMENT PRACTICE**

BDO's Asset Management practice provides assurance, tax and advisory services to asset management entities, comprising hedge, private equity and venture capital funds as well as regulated funds. The practice services over 600 advisors nationwide with funds ranging from start-up funds to those with billions of dollars under management.



## CLIENT ONBOARDING

At the intersection of security and speed sits client onboarding, the process of preparing a client to utilize your platform and products. The first step in initiating any financial relationship is confirming that the parties involved are who they say they are. Thanks to data breaches, hacking and malware attacks, it is increasingly difficult to do that in a way that's both efficient and fool-proof. Given that blockchain promises to drastically reduce, if not eliminate, these issues, it's not surprising that identity management and data security are expected to become the primary applications of blockchain for asset management firms.



## SMART CONTRACTS

Once a client's identity is confirmed and their account is set up, the client is free to start placing orders. Blockchain can receive those requests and trigger a smart contract, programming code that contains the terms and conditions of the requested transaction and automates the approval processes and clearing calculations. If the client's request meets the conditions outlined in the smart contract, the technology can then securely transmit documentation, such as a trade confirmation, and secure funding for the new investment position through automated payment channels. Blockchain allows all of this to happen within minutes rather than taking an asset manager hours or days to complete.



## OPERATIONAL EFFICIENCY

Data transmission speed is an important factor in an industry where firms are now investing hundreds of millions to reduce trade execution time from milliseconds to microseconds. Aside from slashing the time it takes to process orders, faster data transmission times mean managers—both human and of the artificial intelligence variety—will be made aware of breaking news affecting their clients' portfolios that are much quicker and can save them precious seconds in addressing issues as they arise. Finally, the advent of fintech mobile apps and online platforms tied to zero-commission securities trading, as well as the widespread adoption of mobile payments, will open up capital markets and introduce millions of new participants globally to investing and asset management. Increased data transmission speed will be essential in helping firms handle the increased volume and complexity of orders and requests.



## REGULATORY COMPLIANCE

The meticulous, secure and transparent nature of how blockchain compiles transaction data can be beneficial when it comes to investor communication, management reporting and regulatory compliance. Asset managers recognize the advantages blockchain represents in streamlining and automating these monitoring and reporting functions. As managers look to maintain compliance with anti-money laundering initiatives, information security rules and privacy laws, using technology rather than teams of people can help lower costs, increase productivity and reduce the risk of errors or fraudulent activity by individuals.



## NEW OPPORTUNITIES

While most blockchain applications address shortcomings in traditional asset management business models or processes, there are at least two products related to the technology—asset tokenization and cryptocurrency—that represent substantial new investment vehicles for managers to offer their clients:

### Asset Tokenization

Asset tokenization is the securitization of high-value goods like intellectual property, buildings or even famous works of art. The enhanced security and increased speed and efficiency that blockchain represents will allow investors to invest in assets anywhere in the world. While broadening the investor base, increasing liquidity and decreasing resell risk, asset tokenization can also create new barriers to entry for asset managers. With tokenized ownership, parties trade and settle directly within minutes and at low cost, which has the potential to eliminate managers from the equation. On the other hand, many firms are already developing alternative offerings and services to stay relevant to existing investors and attract new business from the expected influx of first-time investors. Any development that promises to drastically increase the pool of potential investors and capital will be a boon to savvy managers.

### Cryptocurrency

Though blockchain is being discreetly applied to everything from food safety to digital voting, most people know it as the technology that underpins cryptocurrencies like Bitcoin. One indicator of the public's growing familiarity with cryptocurrency and, by extension, blockchain, came in 2019, when Starbucks, Whole Foods and Nordstrom started accepting Bitcoin as payment, and Facebook announced the planned 2020 launch of its own cryptocurrency, Libra.

A decade after the launch of Bitcoin, there are now more than 5,000 different cryptocurrencies in circulation, with a combined

worldwide market capitalization above \$275 billion (as of June 8). While that figure is impressive, it's down significantly from a high of more than \$800 billion in January 2018. The "Bitcoin bubble" burst due to uncertainty, volatility and increased regulatory scrutiny, but since then prices have stabilized, and the global regulatory landscape has become clearer. The latest sign of cryptocurrencies' maturation as a mainstream investment option is that their performance is now closely correlated with that of the S&P 500 index. The value of Bitcoin reached a one-year low in March—as did the S&P 500—but it quickly bounced back and had more than doubled in value by May. This has been due in large part to increased interest from institutional investors, some of whom see crypto as an inflation hedge.

### Initial Coin Offerings (ICOs) and Alternatives

Investors interested in digital assets have several alternatives to simply purchasing cryptocurrencies like Bitcoin and Ethereum. The venue that the public is perhaps most familiar with, however, is effectively dead. Initial Coin Offerings (ICOs) are an unregulated form of crowdfunding via crypto assets. ICOs were built around the "fast and loose" ethos of the early days of cryptocurrency, but that lack of oversight and regulation made ICOs a breeding ground for scams and fraud. By the end of last year, ICO funding had plummeted 95% from 2018. A related instrument known as a Simple Agreement for Future Tokens (SAFT) sought to sidestep regulations, but a recent court ruling granted the SEC's request for an injunction and dealt a blow to the viability of that framework as well. As the flaws of the ICO model became apparent and SEC regulation loomed, the crypto industry launched two alternative fundraising tools, Initial Exchange Offerings (IEOs) and Security Token Offerings (STOs), that address those shortcomings in different ways.

### Initial Exchange Offerings (IEOs)

The main difference between IEOs and ICOs is the insertion of a third party, an exchange, between the issuers and investors. These exchanges facilitate the sale of the project's tokens, including marketing the offering and vetting issuers, to prevent the kind of fraudulent activity that sunk ICOs. For investors, IEOs are much easier to participate in than ICOs, which require users to manage complex on-chain transactions directly with the issuers. To take part in an IEO, investors simply register with the exchange hosting that IEO.

### Security Token Offerings (STOs)

Backed by shares in a physical or digital asset, STOs are regulated by the SEC, making them more secure and, in turn, potentially more attractive to risk-averse investors. Unfortunately, this added security and the need for regulatory compliance also make STOs the most costly and complex fundraising model for both investors and issuers.

### Cryptocurrency Derivatives

Another avenue for crypto investment is through the futures and options market. Derivatives are contracts between two or more parties to exchange, sometime in the future, a digital asset at an agreed price. While Bitcoin options are nothing new, the launch of Bitcoin options trading on the Chicago Mercantile Exchange in January 2020 was a watershed moment for the industry. Crypto derivative volumes jumped 32% in May to a record \$602 billion. Futures trading volume rose to \$2.1 trillion in Q1 2020, a 314% increase over the previous quarter's average.

The SEC and crypto industry are working together to strike a balance between regulation and the decentralization that is the hallmark of crypto. One of the SEC Commissioners, Hester Peirce, has voiced support for the establishment of crypto ETFs. In February, Peirce announced a Token Safe Harbor Proposal, and she has also acknowledged institutional investors' growing interest in the crypto space. Peirce was nominated for a second term in June and could continue to serve through 2025, marking another positive development for the crypto industry. As the regulation of cryptocurrency becomes more favorable, and asset managers continue to develop and launch more crypto-related products, we expect more investors to test the waters in the crypto pool.



## THE FUTURE OF ASSET MANAGEMENT

The time for wondering if blockchain is a passing fad has long since passed. Asset managers and the financial services industry as a whole are gradually embracing the benefits and opportunities that the technology can deliver. However, the emergence of blockchain also represents a risk and threat. It opens the door to non-traditional competitors, and it encourages direct interaction between the parties involved in a transaction without the added cost and complexity of a third party.

As digital transformation continues to shape the asset management industry, fund managers should be taking steps to deploy blockchain to improve data and identity security, enhance operational efficiency and streamline regulatory compliance and reporting functions. Otherwise, they risk falling behind. Innovative firms are already working to carve out their niche in new areas of opportunity facilitated by blockchain, such as crypto asset management, STOs and asset tokenization, so the time to act is now.



For more information, please contact BDO's Keith McGowan, Asset Management Industry Co-Leader, Assurance Partner, at [kmcgowan@bdo.com](mailto:kmcgowan@bdo.com).



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## CONTACTS:

### KEITH MCGOWAN

Asset Management Industry Co-Leader, Assurance Partner  
New York  
212-885-8037 / [kmcgowan@bdo.com](mailto:kmcgowan@bdo.com)

### KEVIN BIANCHI

Asset Management Industry Co-Leader, Assurance Partner  
San Francisco  
415-490-3241 / [kbianchi@bdo.com](mailto:kbianchi@bdo.com)

### IGNACIO GRIEGO

Assurance Partner  
San Francisco  
415-490-3182 / [igriego@bdo.com](mailto:igriego@bdo.com)

### DALE THOMPSON

Assurance Partner  
New York  
212-885-7318 / [dthompson@bdo.com](mailto:dthompson@bdo.com)

### MAURICE LIDDELL

Principal, BDO Digital  
Houston  
713-407-3265 / [mliddell@bdo.com](mailto:mliddell@bdo.com)

### KYLE CLARK

Assurance Director  
San Francisco  
415-490-3081 / [kmclark@bdo.com](mailto:kmclark@bdo.com)

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