

BUSINESS

Why blockchain appears poised to become a money-raising force

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For small and medium-sized businesses, private placements to raise capital have a number of drawbacks. A lack of marketing means the owners may have difficulty in identifying investors in the community and elsewhere who are willing to capitalize their firm. The offerings are also paper-intensive and frequently impose restrictions on investors' ability to sell their shares.

But blockchain, the technology behind bitcoin and other cryptocurrencies, could provide a platform for a cheaper and easier alternative to traditional private placements.

If you have been paying attention to the financial press, you have heard of blockchain. It's a type of shared or "distributed" ledger technology that runs on a network of computers to record peer-to-peer transactions among parties authorized to access the network, without relying on centralized, third-party management of the network.

The first steps to constructing functioning blockchain-based alternative offerings and trading markets have already been taken: In 2015, Linq, a subsidiary of Nasdaq, launched a market for trading private company shares using proprietary blockchain technology. Last year, Overstock.com completed an \$11 million offering of "digital" preferred stock to trade on a blockchain-based platform as an alternative to its Nasdaq-listed common stock. And the London Stock Exchange Group PLC, one of the largest global stock market operators, recently announced a joint venture with IBM to develop a blockchain-based alternative market in Italy.

How would a blockchain-based alternative market work? A private company would list its shares for trading, similar to how Microsoft, General Electric, Ford or other companies list their shares on an exchange. But the private company shares would be available only to sophisticated investors — the same people who participate in traditional private placements today — and they would make use of the blockchain-based platform to trade those shares.

And that platform could directly connect the private company with a potentially significant pool of capital: any qualifying investor with access to an internet connection would be able to purchase the company's shares, regardless of where the investor is based. This would be an important step forward for company owners previously limited to raising money from friends, family members and through other formal or informal local relationships.

For several reasons, an alternative blockchain-based market would also be attractive to investors. First, the market would provide liquidity (the ability to more freely sell the shares if the investor desires) for investors, freeing investors from the significant limitations that have customarily been imposed on private company investors.

Second, settlement time — the time it takes for the purchaser to receive the shares he or she bought, and for the seller to receive the cash proceeds from the sale — could be minutes instead of the three-day settlement cycle for publicly traded shares.

Third, a blockchain-based market could potentially reduce processing and trading risks. Reducing settlement time reduces the risk of counterparty default, while reducing reliance on manual processes also reduces the potential for human error in processing trades.

Finally, because of the significant computing power required, it is much harder to hack a blockchain-based system than a legacy technology system.

So what is preventing the widespread development of blockchain-based alternative markets?

To begin with, the technology is new, and has raised a number of challenging legal questions. For example, many state corporation laws currently do not recognize securities issued in "digital" form (although several states are working to address this gap). Additionally, the tools developed over years in "traditional" securities markets to enhance liquidity and price-discovery, such as short-selling, do not currently exist. Similarly, there is no blockchain-based means of borrowing against private company shares. And perhaps most important, the primary securities regulators — including the Securities and Exchange Commission — have yet to meaningfully comment on the benefits or drawbacks of a blockchain-based alternative market; consequently, it's not clear in which direction regulation of a blockchain-based market may go.

There may also be institutional impediments to blockchain development. Consider that implementing blockchain-based processes could potentially eliminate or lessen the roles of intermediary firms and staff involved in securities offerings and trading, including underwriters and operational staff who oversee manual trade settlement and other processes. For example, intermediaries to wealthy individuals or institutional investors may be left on the sidelines when companies can bypass them to directly list their private shares in an alternative market. And in an environment in which shares trade and settle nearly real time through a network of connections, what roles will remain for those who process paper?

Meanwhile, as with so many other elements of the 21st century American economy, those most likely to benefit from the development of alternative blockchain-based markets will be programmers and developers.

Regardless of the challenges, blockchain is here to stay: the World Economic Forum estimates that 80 percent of banks globally will initiate blockchain projects by the end of 2017, and media reports indicate that over \$600 million has already been committed to nonbank financial services blockchain projects, including to trade derivatives and vote proxies.

With potentially billions of dollars of cost reductions at stake, it would be a strategic mistake for those in the securities industry to ignore blockchain's importance.

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