

## Practical Ways Private Equity Managers Can Implement and Take Advantage of Blockchain Technology (Part Two of Two)

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Blockchain technology initially developed nearly a decade ago to underpin and support the cryptocurrency bitcoin, but increasingly, the finance industry is exploring blockchain's potential uses in their own right—in particular, the technology's ability to provide secure, internet-based updates and deliver cost and efficiency savings to back-office functions. Private equity managers, however, have demonstrated more tentativeness than their industry counterparts in warming to blockchain technology, in part due to uncertainty about its purpose, use and reach. This article, the second in a two-part series exploring the applicability of blockchain to the private equity industry, addresses potential challenges to adopting blockchain and best practices for optimizing its implementation. The first article in this series explained blockchain technology, its uses and benefits.

### Challenges to Implementing Blockchain Technology

Among the most compelling reasons to adopt blockchain technology—especially in the current environment in which cyber breaches and compliance with cybersecurity regulatory requirements are top-of-mind for private equity managers—is the enhanced security it provides to transactions, investor information and any other stored or shared firm information. BakerHostetler partner Carol Van Cleef observed, “I would say that one benefit of [blockchain] technology is that there is an added layer of security of information and transactions” accomplished through encryption, which is “at the heart” of blockchain cryptocurrencies.

Private equity managers can only take advantage of the additional security blockchain offers, however, if they can apprehend how the technology works now, how it is evolving and how to concatenate and/or merge blockchain technology with firms' existing systems. One of the most significant challenges right now to implementing blockchain is managers' lack of understanding of how it can be implemented within a firm, and used to make investments, create efficiencies and raise capital for funds.

Stuart Lawson, alternatives global product manager at Northern Trust, said the main drawback of blockchain is that it's still in the infancy stage and continues to evolve. “Business users will therefore need to ensure that there is a robust change control program in place to manage this. In addition, security is often noted as a potential issue. Our experience is that the blockchain system has enhanced security levels with encryption at a higher level not seen before in the financial services industry. There are, however, user controls at the point of access which do need to be robust together with issuance of permissions and private access keys.”

Joshua Klayman, of counsel in Morrison Foerster's financial transactions group, said that because the initial coin offering lifecycle is still in its early states, and blockchain technology in general is still emerging, potential investors may have difficulty fully understanding the potential drawbacks to investing in ICOs and blockchain technology. “I think one issue goes back to the idea of how well the people who are evaluating the investments understand the technology and the limits of the technology that is being proposed.

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I think there often may be a lack of full understanding of the underlying technology and when it can really add value, and that could be among the biggest issues. For instance, with respect to blockchain technology generally, when assessing business models and proposed use cases, it is helpful to ask, ‘Is blockchain technology really needed for the proposed use case? Can that technology add significant value, or would a spreadsheet or database work just as well?’”

For instance, since blockchain technology is relatively new, many IT professionals and managers are unsure how their systems will respond in blockchain. As a result, in the short term, it may not be practicable to make blockchain technology the foundational or sole ledger system a firm relies on until complications are identified and addressed. According to Van Cleef, “As with the adoption of any new technology, you’re probably going to want to run the old and the new side by side for a time to make sure you haven’t lost anything functionally, and it all works the way you want it to work. Depending on the size and the scope of the PE firm’s activities, they may or may not benefit from the use of a ledger-based technology.”

### **Practical Considerations for Implementing Blockchain Technology**

With any new investment or technology implementation, managers first should conduct comprehensive and thorough due diligence on potential portfolio companies under consideration for investment and on how a particular technology will integrate with the firm’s operations. Klayman explained, however, that there are some differences between the types and scope of diligence that private equity funds typically conduct on potential portfolio companies or other investments and the diligence conducted prior to making an investment in the ICO context. “What we’re finding with ICOs is that many investors are investing based on the issuers’ white papers (which describe the characteristics of the token, the technology, the proposed business model and related concepts), which can be very different from how managers traditionally conduct due diligence. There is potential variability among white papers, not only with respect to their clarity and scope but also their accuracy, including from the perspective of how the proposed technology works and whether it is likely to work or be appropriate for the

proposed business objectives, and disclosure.”

Because of the inconsistency in the type of information presented across issuers’ white papers, Klayman advised managers to exercise caution when reviewing them. “This is where managers need to be cautious to be sure they know what they’re getting into and make sure they really appreciate what is in these white papers, which may or may not be well-written or well thought-through from business or technological standpoints.”

From an investment standpoint, Klayman said managers need to have a well-grounded and detailed understanding of the technological information presented in a white paper, the mechanics of a potential deal, how the proposed technology will work and how value will be generated. “Because this is a new space, I think that a lot of investors, which would include some private equity managers, may not have a significant level of sophistication in assessing and understanding ICOs and the underlying technology and tokens, and may have difficulty determining if a particular investment, business model or technology would be likely to actually work,” she noted.

### **Regulations**

According to Klayman, managers must review the relevant laws in several jurisdictions, including the jurisdiction in which they are launching the offering, the jurisdiction in which the relevant entity or entities (such as the issuer) are organized and the jurisdictions in which the manager will solicit investors. “For example, if you’re a U.S. manager that may be marketing to U.S. investors, then a conservative view in the United States is that the token is probably a security, and it is important that you comply with the applicable securities laws, which may include identifying applicable exemptions to registration, such as those available under Reg D and Reg S. This is a simplistic answer for illustrative purposes—there is much more to consider from a regulatory perspective, both in the U.S. and with respect to other jurisdictions.”

In January, the Financial Industry Regulatory Authority published a report discussing Distributed Ledger Technology and certain of the concerns associated with blockchain technology. The report noted the technology offers enhanced transparency and other market

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efficiencies but could also blur the lines between execution and settlement, creating thorny legal and regulatory issues.

FINRA's report also recognized a number of rules that could affect blockchain implementation. In particular, complying with FINRA Rule 4160 and Exchange Act Rule 17a-13, which address asset verification, could be problematic for managers if they cannot determine which institutions hold which assets or develop processes to verify maintenance of those assets.

The regulatory overhang could have a big impact on the value of the potential investment, Klayman added. "Among other things, there are KYC and AML issues, in particular, that managers need to consider. With these ICO transactions, you really need to understand who your investor is. You don't want to violate securities laws and other regulatory legal frameworks, and managers should be concerned about that. The managers that are raising funds or who are helping to facilitate ICOs for the companies they invest in should focus on doing so in a legally compliant manner and doing what needs to be done to understand who they are doing business with and who their investors are."

Van Cleef also noted, "Several states have been making changes in laws to recognize transactions that are happening across the blockchain in the same way they would recognize any other transaction. Delaware and Illinois have been leaders, but a number of other states have made or are considering similar changes."

#### Policies and Procedures

Depending on how a private equity manager uses blockchain, internal policies and procedures relating to trading, capital raising or operational processes may need to be updated, Van Cleef advised. "When developing related policies and procedures, it depends on what the business model is. First and foremost, what you're doing is using a new piece of software to presumably replace something you already had. You have to look at how things are being done now and how they will be done differently with this technology to see if policies and procedures and practices still apply and that your practices still comply with applicable federal and state laws and regulations including

money transmission, securities laws and anti-money laundering."

#### Best Practices

Managers should carefully deliberate whether to implement blockchain and formulate a methodology and plan for how it will integrate with a firm's existing operations, systems and networks.

According to Lawson, "There are a number of platforms available from suppliers, such as Microsoft and IBM, which can be deployed. However, the technology is extremely flexible, and so a successful program will require careful planning and management to ensure business requirements are clearly articulated and built into the design. We expect many PE houses will look to larger financial services groups with a proven product to provide the service."

Rik Willard, founding and managing partner at Agentic Group, advised managers to pay close attention to the blockchain industry to monitor developments and learn any new uses of the technology that would benefit their firms. "Fund managers need to track the space assiduously and really pay attention to some of the applications that are gaining traction in this space to see where the value propositions are, because those are going to continue to evolve over the next couple of years. I would hold off on implementing blockchain internally until you really have a grasp of what the potential applications are in the marketplace and are able to internalize that thinking in such a way that it is actually efficient for you."

For managers considering an ICO, Klayman cautioned, "If you're at a fund that is considering launching an ICO or helping a company that has an investment to conduct its own ICO, you should make a concerted effort to comply with existing securities and other applicable regulatory frameworks of the jurisdiction in which you are launching the ICO, as well as the jurisdictions in which you are marketing, offering and selling the tokens. Just because a jurisdiction may not have developed regulatory guidance that is tailored to, or addresses, blockchain or digital currency offerings, does not mean that no existing regulatory framework or requirements will apply to the ICO."

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Klayman also advised managers launching an ICO in the U.S., or those marketing, offering or selling tokens to U.S. persons, to assume that the tokens will be characterized as securities and treat the offering like a securities offering and try to find an exemption from registration that can apply. “You need to try to be compliant with applicable securities laws and other regulatory frameworks. Many recent ICOs don’t even have an offering memorandum, they just rely on smart contracts, white papers and certain limited disclosures. I would advise managers to treat this as they would any other capital raise and put in the time to achieve compliance with applicable laws. Just because some companies may not be complying with regulatory frameworks does not mean that those rules and laws do not apply.”

Because of the different applications for blockchain and the evolving market for the technology, Klayman noted that it is important for managers to really understand what they are getting into. “You need to know there are applicable securities laws and other regulations around the world that you have to be sure you don’t violate. You need to understand the legal grey areas that may exist with respect to this emerging space and understand the risks that may exist, including the risks that regulators begin to become more active in enforcing compliance with regulatory frameworks. You also need to understand, and to be sure that your disclosures (including risk factors) accurately describe, the various types of risks to investors and the fund that exist that may be particular, for example, to blockchain, digital currency and ICOs.”

Klayman reiterated the importance of consulting with attorneys knowledgeable in the distributed ledger technology space and exercising the same degree of fastidiousness, from a regulatory compliance perspective, with ICOs as a manager would with any other securities offerings. “I would advise managers who are contemplating launching ICOs to take a conservative view and approach these offerings as they would other potential offerings of securities and to comply with the relevant laws of the applicable jurisdictions, just as they would in the context of a non-blockchain, non-digital currency, non-ICO context. Just because the technology and jargon may be new, does not mean that existing laws do not apply.”

Finally, Van Cleef advised managers to give significant forethought to how they will use the technology. “Blockchain is software. Private equity managers wishing to utilize it need to look at the processes they have in place and their funds flows to see how to best use the technology to make their systems and processes more efficient. The imagination is the only limitation with this technology. How this technology is implemented will vary case by case, industry by industry and use by use.”