

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

Until recently, blockchain and bitcoin were nearly synonymous—the former was created in 2008 to underlay the latter, and the controversial cryptocurrency still remains by far the most widespread use of the latter’s distributed database structure. But increasingly, it’s not the only one: The financial industry is experimenting with blockchain technology, and the success of those efforts could ultimately transform the way assets are transferred. In the past few months, for example, blockchains have been used for administrative purposes by a private equity fund; to record the purchase and sale of mutual fund shares; and by a newly launched peer-to-peer lending hedge fund to deliver to investors a public ledger of, among other things, all investments, payments and loan details in real time. These initiatives provide evidence that blockchain technology has begun to penetrate the asset management industry.

The banking sector, and recently, hedge fund managers, have been most receptive to utilizing blockchain for certain back-office operations, but private equity managers have been slower to adopt the technology (despite the PE fund administration example above), in part due to uncertainty about its purpose, use and reach. This article, the first in a two-part series exploring the applicability of blockchain to the private equity fund industry, explains the technology, its applications and benefits. The second article in this series will address the drawbacks for private equity managers utilizing blockchain and best practices for optimizing its implementation.

What is Blockchain?

At its most elemental, a blockchain is a decentralized ledger of transactions across a peer-to-peer computer network. Blockchains are ‘decentralized’ because all users authorized on the network can have their own synchronized copy of the ledger. They can all see and confirm that a transaction has occurred and has been recorded, at the same moment in time. Instead of connecting to a central authority through a hub-and-spoke model, then, every participant has a computer linked to other participants.

Rik Willard, founder and managing partner at Agentic Group, summarized blockchain technology’s attributes. “A blockchain is an immutable, unchangeable, uncrackable record of transaction.”

Why Would a PE Manager Use Blockchain?

The attraction of blockchain to private equity managers is a matter of secure and unchangeable recordkeeping, which can ultimately result in increased operational efficiency.

Specifically, blockchains’ “irreversible and immutable” record is a significant attraction, said Carol Van Cleef, a partner at Baker & Hostetler. “The process of hashing that creates the blocks that make up the blockchain results in the creation of a record that effectively timestamps the information posted to the blockchain – it records when something happens so that if there is a question at a later time you have a record that is indelibly time stamped – forever.”

Stuart Lawson, alternatives global product manager at Northern Trust said that private equity managers securely execute and store records of transactions on blockchains. “All original fund records can be securely executed and stored on the blockchain and made available to all users who are ‘permissioned’ to use it. It creates a single version of the truth, which all participants can access and rely on, including advisers, auditors and regulators. Transactions which involve multiple participants, such as a capital call, can be fully processed on the platform with all the requisite approvals, document delivery and movement of cash seamlessly processed with minimum intervention.”

Willard noted that blockchains have several other practical applications for private fund managers—in particular, increased transparency and efficiency. “In terms of operations, blockchains can produce increased transparency, smoother data flows, efficiencies in custodianship and more automated compliance.”

Blockchains also present a potential solution to increasing operation efficiency in the current fundraising environment, in which PE firms may struggle to stay competitive as LPs exert downward pressure on management fees, operational expenses and transparency because they can transact more expediently and provide LPs with more data on investments.

In addition, PE managers can use blockchains as a method for transferring funds. “Because blockchains are immutable ledgers, payments can potentially be verified, tracked, processed and distributed on the same ‘rail,’ which may in time reduce the need for traditional banking and the associated costs of money transfer, which can be significant with large sums,” Willard explained.

Initial Coin Offering

According to The Economist, Initial Coin Offering “coins” are essentially digital coupons, tokens issued on an indelible distributed ledger, or blockchain, that can easily be traded. Unlike shares, however, they do not confer ownership rights. Investors hope that successful projects will cause tokens’ value to rise.

ICOs are another potential use of blockchain for private equity managers, and Willard said they’re bypassing the traditional ways of funding startups. “It’s a great way of not giving away equity but still getting funding which can, theoretically, appreciate over time through use of that particular platform. For funds, they would look at the accumulation of different kinds of tokens from different ICOs, and then algorithmically predict winners and losers.”

Joshua Klayman, of counsel in Morrison Foerster’s Financial Transactions Group, said she has observed sharper attention to ICOs simply because they have raised a great deal of capital. “In addition to inquiries from startups and established companies, we’ve been getting a lot of inquiries from PE and VC funds. One interesting development is that the funds are asking questions about, and contemplating, both helping to structure ICOs for some of the companies in which those funds have investments, as well as potentially structuring funds with an ICO model (where the fund itself would have an ICO). Some funds specifically ask about replicating or emulating aspects of the recent Blockchain Capital ICO structure.”

Funds are also trying to create a fund via an ICO rather than raising capital in the traditional way, Klayman noted. “If you look at the way that Blockchain Capital (with Argon Group) approached its ICO model in Singapore, they made an effort to comply with existing securities regimes of various jurisdictions—for instance, there was an offering memorandum, and, with respect to U.S. securities laws, they availed themselves of Reg D and Reg S to raise capital.”

Van Cleef pointed out, however, that ICOs may be changing the market in disadvantageous ways for private equity managers, because they beget more potential investors at the table in potential deals. The implication is that private equity managers may get less of a stake in a portfolio company than they could have. “ICOs have the potential to impact significantly the traditional private equity markets, which historically have been relatively limited to insiders,” she explained. “ICOs are disruptive because they democratize private equity investing – more and different people are able to invest in deals they would not have had access to in the past. ICOs also change the dynamics between the company and the investors. The companies are not beholden to one or a few investors who have the ability to

dictate more favorable terms. With more potential investors now 'at the table' and greater competition between investors, the company has more and less expensive options. ICOs effectively put more control back into the hands of the company, they broaden the range of potential investors and makes it less likely that a single investor or a group of powerful investors could dictate the terms of the investment."

Blockchain Fund Administration

Northern Trust Corporation recently utilized blockchain for a PE fund's administration. The blockchain solution streamlines subscription and capital call processes and offers PE fund managers a shorter time to market, because they can collect customer funds more quickly, since steps in the manual process often involve signing and reviewing subscription agreements and wiring funds and are eliminated in lieu of a purely electronic data process.

Lawson explained how Northern Trust's blockchain administration works. "Each participant or 'actor' is given permission to access the system and is provided with their own copy of the database via a node. Actors include managers, investors, auditors, advisers and regulators who can keep their 'node' on a server of choice. All nodes remain synchronized, with any changes being subject to approvals built into the system and a consensus mechanism that ensures, from a technical perspective, the nodes all remain perfectly aligned. For example, if a manager wishes to call more capital for a new investment, they can access the system to record the request."

"A 'smart contract' determines which approvals are required and arranges for approvals to take place and, if necessary, for formal meeting minutes to be produced and signed by a designated person," he continued. "The call notice will then be issued to investors with an option to automatically collect the requested funds from the investor if they have provided the requisite authority."

Although not an actual legal agreement, these smart contracts perform a set of predetermined rules and recognize certain triggering events to self-execute transactions involving multiple parties and multiple agreements.

"The system removes a lot of process friction caused by paperwork and approval chains embedded into current PE fund processes," Lawson noted. He added that blockchain can "effectively create a highly secure digital environment in which all participants can access and record their preferences or decisions, create requisite documents and records, and also provide auditors, advisers and other participants access to a single immutable version of the truth at any given point in time. The system can also limit access to records by using private keys, which only decode the encrypted data that the participant is allowed to see. A prospective investor may be given permission to see certain principal documents but not a full transaction history, for example."
