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Can NFTs solve the fund industry's liquidity problems?

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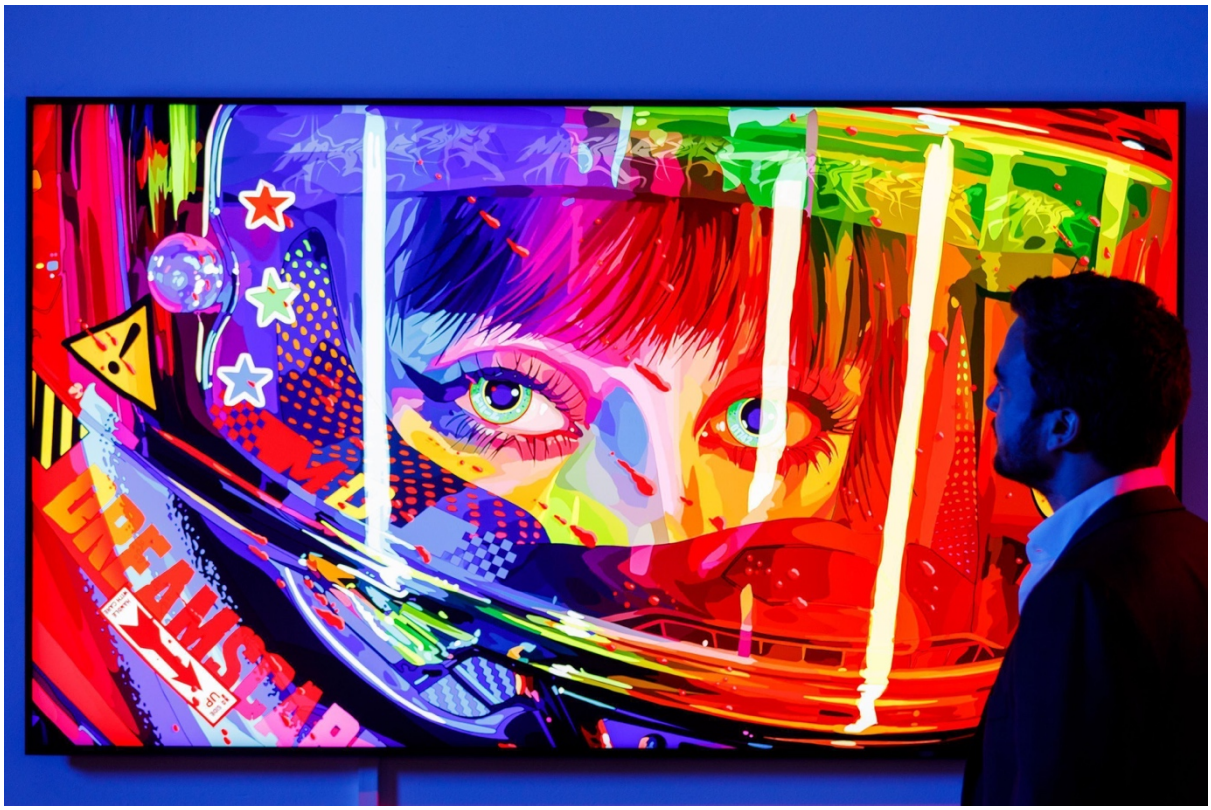

Have you ever thought of spending millions of dollars for the right to own a cartoon monkey, of which no trace exists in the physical world? If so, you are not the only one, as the recent buying craze for so-called non-fungible tokens shows.

NFTs, which are based on blockchain technology, have enabled the likes of digital collage artist Beeple, the musician Grimes and a 12-year old boy from London to sell artwork for large amounts of money to fans, even though the buyer, who pays with cryptocurrencies, never receives any form of physical asset.

What NFT buyers do gain, however, is a virtual certificate of ownership, verifying that they are the sole and rightful owner of the digital asset.

Some believe that after upending the art market, digital tokens could revolutionise the asset management industry too, reducing liquidity and operational risk while opening up funds to a wider range of investors.

NFTs were auctioned at Sotheby's, the London auction house, earlier this year
Peter Habermacher, chief executive officer of Aaro Capital, a London-based boutique that invests in distributed ledger technology, says funds can deploy tokens to denote ownership of a fund just as artists use NFTs.

“It is a different permutation of the technology but the principle is the same,” he says.
While both NFTs and fund tokens would be using smart contracts to register investors, funds would likely deploy fungible tokens, which unlike NFTs are interchangeable and can be split into smaller units.

Smart contracts are computer programmes based on a distributed ledger such as the ethereum blockchain that execute a transaction, impose controls or document an activity when specific circumstances are met.

Fund managers could tokenise a physical asset such as a new real estate development or infrastructure project, providing investors with a digital record of their investment, using smart contracts to register and transfer ownership of a share of the asset or product to an investor.

As well as potentially opening up alternative investments, which tend to have a high entry threshold, to a wider range of investors, Mr Habermacher says one of the key attractions of using tokenisation is that it could increase the underlying liquidity of what are typically illiquid asset classes.

“Tokenisation can be seen as the next step of securitisation, reducing friction and administration costs, and creating liquid markets where there was no liquidity before,” he says.

Fund liquidity has become an area of increasing concern for regulators in recent years, following some high-profile liquidity mismatches and the struggle of some open-ended funds investing in illiquid assets to cope as investors raced to convert their investments into cash as much of the world entered lockdown in March 2020.

The prospect of increasing liquidity in illiquid funds has led a number of large asset managers to explore how they could use tokenisation, according to two people with knowledge of the situation.

Anne Richards, CEO of Fidelity International, told the recent Digital Asset Summit in London that investments in infrastructure could be well suited to tokenisation.

Martin Cornish, principal at law firm MW Cornish & Co, says fund managers managing illiquid assets “can see the attraction” of tokenisation as alternative asset classes as “it can create greater liquidity” by enabling a greater pool of investors to invest in illiquid assets.

“The difference between art and financial services is that one market is regulated and the other is not”, says Anders Kvamme Jensen founder of AKJ Group, a crypto hedge fund ecosystem.

However, Mr Cornish cautions that dispensing tokens and administering investors on the blockchain is unlikely to generate enough liquidity by itself as “at that point you have not really done anything different [from normal] other than using a different type of ledger”. “To create proper liquidity you almost certainly need to list on an exchange and there are not many exchanges that have the capacity to take these products on,” he says.

Amarjit Singh, blockchain assurance lead for Europe, the Middle East, India and Africa at EY, adds that “tokenisation is not a magic bullet for liquidity”.

Mr Singh says fund managers considering tokenising physical assets “need to think about where the liquidity is going to come from”.

“Tokenisation will help make it easier to trade fractional ownership but investors should be mindful that the price they get in a liquidity crunch may be severely discounted, just as in normal financial markets,” he says.

Large regulated asset managers, particularly those catering to the retail market, are unlikely to use tokenisation on a wide scale until the practice gains regulatory approval.

Anders Kvamme Jensen, founder of AKJ Group, a crypto hedge fund ecosystem, says the lack of approval from leading regulators such as the Financial Conduct Authority is putting off large asset managers and institutional investors from tokenising their funds.

A person familiar with the situation says a key issue for regulators is that the current state of the tokenisation industry would make it difficult for fund managers to meet their anti-money laundering regulatory obligations.

“Fund tokenisation is the same concept as NFTs. The difference between art and financial services is that one market is regulated and the other is not,” says Mr Kvamme Jensen.

(ends)