

<http://www.garp.org/#!/risk-intelligence/detail/a1Z40000034FOfEAM/deleware-welcome-mat-blockchain>

Delaware's Welcome Mat for the Blockchain

The "corporate state" launches a distributed ledger initiative that could bring sweeping changes to issuance and processing of company shares

By John Hintze

May 20, 2016

Do investors own the shares in their brokerage accounts?

Technically speaking, they do not. U.S. stocks and bonds are typically held by brokerages in "street name" on behalf of their clients. That could start to change as soon as next year, when the State of Delaware and private-sector collaborators plan to enable companies to incorporate using distributed ledger technology rather than old-fashioned certificates. The result could be greater efficiency, lower risk and a new generation of automation in market operations.

It is an application of blockchain technology that could be disruptive to the Depository Trust & Clearing Corporation (DTCC), the clearing and settlement utility where companies' ownership certificates actually reside and which grants contractual rights to investors purchasing the securities. And if the Delaware plan comes to fruition, a range of operationally complex processing steps will no longer be necessary. Significant benefits could accrue to corporate issuers and investors, while intermediaries' roles may change dramatically.

Delaware Governor Jack Markell, whose state is the legal domicile of two-thirds of the Fortune 500 and 85% of U.S. initial public offerings, announced an initiative on May 2 to represent share ownership using the secure, open-source distributed ledger technology that was originally associated with Bitcoin.

Instead of stock certificates, shares would take the form of smart contracts, or protocols that mimic the functions of shares and are self-executing.

"Smart contracts offer a powerful and innovative way to streamline cumbersome back-office procedures, lower transactional costs for consumers and businesses, and manage and

reduce risk,” Markell said in a [statement](#) that coincided with his keynote speech at the Consensus 2016 conference in New York.

Incorporating through such a ledger will benefit start-ups from early funding rounds through the IPO process, and even long-established companies with millions of shares outstanding could also see the fruits of distributed ledger technology.

Legal Framework

Distributed ledger systems are being tested by numerous banks, and post-trade or smart-contract applications are being explored by new ventures such as [Digital Asset Holdings](#) and [R3CEV](#) and incumbents including DTCC and [ICAP](#). For what Delaware is proposing, Pillsbury Winthrop Shaw Pittman is working to create a framework to make the transactions legally enforceable. Marco Santori, who heads the law firm’s team focusing on distributed ledger technology, said amendments to finalize the legal framework should be presented to the Delaware legislature early in the session that begins next January.



Announcing Delaware’s blockchain initiative, Governor Jack Markell described smart contracts as “powerful and innovative”.

The provisions will enable private issuers to make use of a distributed ledger, which could be one that [Symbiont](#) has developed to support financial transactions, or another, such as

the Bitcoin blockchain. Symbiont issued its own shares last year via the blockchain to demonstrate that such transactions can be done over a public ledger.

Cost- and risk-reducing benefits would then flow to regulators, investors, and especially issuers. For private firms that now send paper certificates to shareholders, a key benefit will be having an immediately accessible and immutable record of the chain of title. At any given moment, principals could view the current state of ownership and avoid future surprises.

“Today, the longer a company is private, the more investors it has, and it loses clarity about who owns the shares and what they’re doing with them,” said Symbiont chief executive officer Mark Smith.

Easier Communication

With that visibility of its “cap table,” or ownership structure, a company can communicate directly with investors through the ledger, instead of relying on emails or physical mail.

Proxy votes can also be managed without the costs and complications of paper documents. Likewise for corporate actions such as dividend payments and K1 partnership distributions — the distributed ledger reduces friction and costs and creates an immutable record that becomes a basis for tax filings.

Compliance-related liability should drop, as, for example, rules governing when shares can be sold will be automated.

“All these compliance functions can be programmed directly into the smart contracts to occur automatically,” Smith said.

Regulatory Clarity

From a regulatory perspective, access to the immutable record of firms’ payment structures will give Delaware authorities and the Internal Revenue Service clear insight into firms’ financial activities.



Immutable smart-contract records can be a boon to companies taking steps to go public, says SenaHill Partners managing partner Neil DeSena.

Smith added that using a distributed ledger should eliminate the problem of over-issuance, when the state authorizes a certain number of shares but companies issue more. Further, the risks inherent in physical certificates — as in the case of DTCC’s having to recover 1.7 million certificates from vaults flooded by Hurricane Sandy — would go away.

Neil DeSena, managing partner of [SenaHill Partners](#), said at least half of the 20-plus start-ups in its fintech portfolio plan to re-incorporate using Symbiont technology, reissuing existing private shares on a distributed ledger. (SenaHill is an investor in Symbiont.)

“Everything that’s put into a legal document, relating to managing those shares, now gets put into a smart contract that takes in a couple of feeds — the atomic clock and maybe a data feed from Bloomberg or Reuters — and it knows when to do what,” DeSena said. “All the manual stuff goes away.”

DeSena said that a company created on a private ledger and using smart contracts will have all pertinent corporate events immutably recorded and, hence, provable, a boon if it later plans an IPO. He added that the investment banks and law firms involved in IPOs today would likely still play legal, compliance and due diligence roles, but specific jobs may change.

“Maybe there will be a different way to do due diligence or distribution, but you’ll still need that registered entity in between issuers and investors,” DeSena said.

Long-Term Transition

Large private companies such Uber and Airbnb would have to do additional work to get approval from shareholders to destroy paper certificates and instead accept smart contracts, since they typically have many more shareholders.

Public companies, even those with millions of shares outstanding, could presumably take advantage of distributed ledger technology and may feel competitive pressure to do so given its efficiencies. However, the Securities and Exchange Commission will first have to allow companies to choose a digital representation of ownership rather than certificates.

Symbiont’s Smith said that states, where that ownership is created, will have to become comfortable with the technology. Any eventual destruction of physical certificates would surely take a while.

“I think the way the DTCC and custodial banks do their business today will cease to exist in 10 years,” Smith said. Noting that those entities are actively involved in distributed ledger [research and experimentation](#), he added, “Either they’ll be the butcher or on the chopping block. That’s why they are so far out ahead of much of the industry.”