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Security Token liquidity: Are we there yet? Are we there yet? When are we going to get there?

For the last few years, the potential for security tokens to disrupt traditional financial markets has been a beacon of hope to blockchain enthusiasts and investors and a mantra chanted at many blockchain conferences.

Of course, the prospect of tokenising conventionally illiquid assets, so as to make those assets accessible and tradeable with minimal transaction costs, virtually no minimum investments, and everywhere at anytime is a tantalising prospect. To date, those hopes have yet to crystallise at scale.

Among countless theories as to why, Brian Farber, General Counsel at Securitize, recently published his thoughts summarising the four key reasons why he believes that security token liquidity has failed to meet expectations to date, including:

1. Security Tokens are inherently difference to cryptocurrencies;
2. Information asymmetry prevents effective valuation;
3. Security Token marketplaces are young, and not designed optimally; and
4. Blockchain is both a blessing and a curse.

We consider each of these issues below.

Security Tokens are inherently different to cryptocurrencies

Broadly, Farber argues that the key fallacy underlying hype for security token liquidity is the implicit assumption that security tokens would trade with the volume and frequency of public equities or cryptocurrencies, despite the fact that digital securities today almost exclusively represent private securities and public equities.

Farber rightly argues that private securities, such as shares in privately owned company or units in a trust representing a particular asset, will never be traded with the same volume or frequency of a listed equity due to the inherent differences between those assets.

The transfer of privately held securities, or other financial products, is already a legally complex process. Conventionally, it involves various third parties including lawyers, accountants, custodians and brokers among others, who facilitate the payment of forms, notification of regulators, management of company and public ownership registers, all of which takes time and money. Of course, issuers or brokers of security tokens can use smart contracts to automate much of this process.

As Farber notes:

"*While the inherent limitations of a private digital security prevent it from bouncing around with the fury of cryptocurrency, it undoubtedly provides liquidity enhancements over its off-chain analogue*."

However, it is much more difficult (but not impossible) to automate particular regulatory requirements that could apply to individual security tokens, and not others. For example, many, if not most shares in private companies in Australia entitle the holder to certain contractual pre-emptive rights to be issued with further shares before new investors, or before shares are sold to third parties by other holders. Alternatively, the holder might have contractual rights of first or last refusal, or restraints on trade, vesting rights, and any number of other highly individualised rights or obligations that must be

considered. Similarly, the issuer itself is likely to be subject to its own restrictions, such as restrictions on the number of shareholders it can have, transfer restrictions or notification requirements. Until these issues can be managed more consistently (and more transparently, discussed below), this problem will remain.

Information asymmetry prevents effective valuation

Farber correctly notes that:

"*Meaningful liquidity will never manifest without the flow of timely and accurate information. At a minimum, institutional investors won't participate in a market if they cannot properly value assets when acquiring them*. "

and

"*Issuers and marketplaces expected the liquidity of the public equity market without the corresponding burden of disclosure*."

Of course, without sufficient information about the asset or entity represented by a security token, there is no efficient way to evaluate the price or underlying value of that token. This is already a problem in traditional secondary markets for shares in private companies, and there is no reason why it ought to apply differently to security tokens.

Farber suggests that security token marketplaces could address this issue by requiring a prescribed level of disclosure to users of the marketplace, not unlike the continuous disclosure obligations of the ASX, or the US Securities Exchange Commissions Rule 144A requirements. Putting the ASX disclosure requirements aside, even private companies in Australia must meet stringent disclosure requirements for the issue of shares in all but the most narrow of circumstances.

Security Token marketplaces are young, and not designed optimally

Farber then argues that:

"*Most digital security marketplaces were designed with high-frequency trading in mind. Their colorful order books and flashing numbers are reminiscent of crypto platforms but aren't built for the reality of private digital securities*"

These issues can, in our view, be attributed mostly to a lack of market maturity, coupled with the issues identified above. Farber proposes a scaled-back "bulletin board" style marketplace as a potential solution, which priorities consistency and information disclosure over volume transparency in the short to medium term.

Blockchain is a blessing and a curse

As many blockchain-based platforms have discovered, building on blockchain often leads to a host of new problems. The most common problems include convincing customers and legacy service providers that the technology is safe, and explaining the rationale for the different approach.

On a more technical level, Farber notes that using blockchain leads to difficult regulatory problems, including a lack of guidance as to how requirements around custody and asset servicing can be met. This has been a recurring concern for regulations all over the world, and particularly the SEC as it noted in its July 2019 joint statement with FINRA.

So what next?

While high volume, high frequency trading may be suitable for some cryptocurrencies, expecting the same for security tokens ignores the underlying fundamentals of the assets they represent, and disregards the reason why digital securities exist in the first place. Automated liquidity and smart contract processes that can interface with security tokens are only likely to increase (we are already seeing smart contracts creeping into Wall Street securities).

Ultimately, the answer may just be that good things take time.