The Future of Cash May Be a Token

How Tokenized Money Market Funds May Reshape Institutional Cash Management

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Introduction

Cash may be King, but it is also going virtual before our eyes. Digital cash used to be the domain of tech innovators and cryptocurrency enthusiasts. But if a pair of tokenized money market mutual funds (MMFs) is any indication, instantaneous movement of cash untethered to market hours may be close to reality. If today's experimental projects work through regulatory, legal and operational hurdles, blockchain-enabled MMFs may revolutionize what institutions view as cash. So, it's time to get serious about understanding how the future of digital cash may disrupt the traditional MMF ecosystem by enhancing efficiency, liquidity and risk management for institutional investors.

The first U.S.-registered MMF to utilize a public blockchain for share transactions and ownership records was the Franklin OnChain U.S. Government Money Fund (FOBXX), launched by Franklin Templeton on April 6, 2021. [1] WisdomTree followed in November 2023 with the WisdomTree Government Money Market Digital Fund (WTGXX). [2] Crypto news site CoinDesk reported recently that the cryptocurrency exchange Coinbase also plans on launching a tokenized MMF. [3]

The failure of several banks in the spring of 2023, triggered by runs on uninsured deposits, coincided with large inflows into the Franklin Templeton fund as crypto-related entities shifted their cash destinations. A downturn in the crypto market and no income returns on stablecoins also drove investors to the fund. [4]

And on March 20, 2024, a game changer emerged when BlackRock, the largest fund manager in the world, introduced the BlackRock USD institutional Liquidity Fund (BUIDL), a digital token fund. BUIDL is not a MMF but a liquidity fund pursuant to Rule 506(c) for accredited investors with "instantaneous and transparent settlement" and a stable value of $1 per token (share).[5]

Tokenized MMFs: a Primer

The funds have a few things in common. They are either MMFs or, in the case of BUIDL, a quasi-MMF, that invests in safe instruments such as cash, Treasury and government securities, and repurchase agreements backed

[1] See FOBXX's SEC Form N-1A filing dated September 3, 2019, www.sec.gov/Archives/edgar/data/1786958/000113743919000429/fttn1a092019.htm.
[2] WTGXX's fact sheet here, www.wisdomtree.com/investments/digital-funds/money-market/wtgxx.
[3] Ian Allison, "Coinbase Asset Management Plans Tokenized Money-Market Fund, a Hot Area After BlackRock's BUIDL Success: Sources," CoinDesk, July 24, 2024, www.coindesk.com/business/2024/07/24/coinbase-asset-management-plans-tokenized-money-market-fund-a-hot-area-after-blackrocks-buidl-success-sources/.
[4] Gaurav Roy, "Franklin Templeton Plays a Pioneering Role in the On-Chain Money Market Fund," Securities.io, October 24, 2023, www.securities.io/franklin-templeton-plays-a-pioneering-role-in-the-on-chain-money-market-fund/.
[5] "BlackRock Launches Its First Tokenized Fund, BUIDL, on the Ethereum Network," Securtize.io, March 20, 2024, securitize.io/learn/press/blackrock-launches-first-tokenized-fund-buidl-on-the-ethereum-network.

by government securities. Shares are offered at a stable $1.00 net asset value. Setting aside regulatory and investment policy considerations, these features indicate that tokenized government MMFs may be suitable for institutional cash accounts.

The funds use a blockchain technology called tokenization to process share transactions between parties and record share ownership in a verifiable and permanent way with cryptography. Tokenization is a computer routine that permanently converts real assets, such as MMF shares, into digital "tokens" on a blockchain network. A blockchain is a decentralized and immutable ledger with "growing lists of records (blocks) that are securely linked together." Each block preserves all the transaction data, time-stamped and contained in the previous block, forming a chain. [6] In the case of tokenized MMFs, each token represents a share worth $1.00 with a history of "who owns what where."

In the world of finance, recording securities ownership and movement on physical and computer ledgers is notoriously complex and labor intensive. Restrictions on trading hours and legal requirements over financial transactions delay cash movements. Industry innovators have long worked on using blockchains to improve accessibility, liquidity, efficiency and transparency in these instruments. U.S. Treasuries are at the forefront of tokenization as tech and financial companies seek to put the largest, deepest, and most liquid financial instruments on blockchain. Treasury-based offerings including government MMFs are popular for this purpose.

To reach a happy medium between traditional and digital worlds, the funds use tokenization as a "secondary recording," meaning each record is replicated in real and virtual spaces. Franklin Templeton believes that SEC-regulated MMF shares existing as native digital assets on a blockchain and held in a digital wallet "can be an ideal stable digital asset to be used in the new economy." WisdomTree's transfer agent maintains the official record of share ownership in book-entry form as well as on an electronic distributed ledger called Stellar. BlackRock touts BUIDL's "interoperability" between digital and traditional markets, using Bank of New York, a large custody bank, to handle the tasks. The "dual listing" of fund shares adds to administrative costs in the short run but allows market participants to test out new concepts before wider adoption.

Digital asset data company RWA.xyz tracks $1.9 billion of tokenized Treasuries as of August 9, 2024. On that date, total net assets for BUIDL, FOBXX, and WTGXX were $513 million, $420 million, and $8 million, respectively.

Tokenized MMFs Are Not Stablecoins

Tokenized MMFs are different from stablecoins despite both using blockchain technology. Financial regulators often view stablecoins as unregulated MMFs with systemic implications for the short-term debt market, a concern not shared with tokenized MMFs.

Nature and Purpose: Tokenized MMFs are traditional MMF shares digitized with blockchain technology. They seek to replicate bank deposits with marketable securities for liquidity investors. Stablecoins are digital currencies designed to maintain a stable value relative to a reference asset like the U.S. dollar. They do not replicate bank deposits, but they are designed to be a reliable medium of exchange and store of value in the crypto ecosystem.

Underlying Assets: MMFs invest in Treasury bills, repurchase agreements and other short-term debt instruments. Tokenized shares represent pro rata ownership in the underlying instruments. SEC rules prohibit all MMFs from investing in stablecoins, cryptocurrencies, or other assets that rely on blockchain technology. Stablecoins, on the

[6] "Blockchain," Wikipedia, en.wikipedia.org/wiki/Blockchain.

other hand, can be backed by many types of collateral, including fiat currencies, cryptocurrencies, or algorithms. Stablecoin owners do not have a direct claim against the collateral.

Regulation and Compliance: Tokenized MMFs are subject to the same regulatory frameworks as traditional funds that provide investor protection. The regulatory environment for stablecoins is still evolving.

Liquidity and Settlement: Tokenization can enhance MMF liquidity and settlement efficiency. Ideally, transactions can be settled almost instantaneously on a blockchain, reducing settlement time and costs. Stablecoins' settlement is also near-instantaneous across global markets, thanks to the blockchain technology.

Investor Base: Tokenized funds are primarily for institutional investors seeking a digital alternative to traditional MMFs while maintaining regulatory compliance. Stablecoins are widely used as the crypto ecosystem's equivalent of MMFs for various purposes, including trading, remittances, and hedging against volatility in the cryptocurrency markets.

Potential Benefits to Institutional Cash Management

Improved Liquidity with Potential for 24/7 Cash Availability: While not a reality yet, tokenized MMFs have the potential to enable near-instantaneous settlement time by automating processes through smart contracts as opposed to end-of-day or T+1 settlements in conventional fund processing. The improved liquidity may allow institutional investors to access their funds more quickly and efficiently, especially given the global nature of modern business operations across time zones and national boundaries.

Operational Efficiency and Cost Savings: By automating transaction processing and record-keeping, tokenization reduces the need for intermediaries and manual intervention. Automation can lead to improved efficiency and lower costs, which can be passed on to investors in the form of lower fees or higher yields.

Better Diversification and Yield Potential: Tokenized MMFs may allow institutions to participate in a more diversified group of funds by geography and underlying investments, leading to better diversification and potentially higher returns. Tokenization can also open doors to other forms of cash management vehicles, such as tokenized commercial paper.

Enhanced Transparency and Regulatory Compliance: Recording all transactions on a secure ledger provides an immutable record and real-time visibility into holdings. This can help investors better understand and track their investments, potentially reducing error rates. The decentralized nature of blockchain can add an extra layer of security, making it more difficult for malicious actors to compromise data security. Smart contracts can also enable better compliance with predefined rules and regulations and automate reporting requirements.

Challenges and Potential Implications

Despite the potential benefits, MMF tokenization also faces several potentially daunting challenges to adoption by institutional cash investors.

Regulatory Frameworks: The regulatory landscape for tokenized financial products is still evolving. As the financial industry is heavily regulated, this can be a complex and time-consuming process, requiring collaboration with regulators and other stakeholders on issues surrounding custody, compliance, and investor protection. Institutional cash investors also need to face this uncertainty and ensure compliance with existing and emerging regulations and investment policies.

Disruption to Traditional Banking and Cash Management: Tokenization has the potential to disrupt traditional banking and cash management practices and challenge existing business models. Fund managers, trading platforms, and custody banks may need to adapt their strategies to embrace the digital revolution and remain competitive in the newly developing landscape. Digital adoptions by MMFs may also influence dynamics in other parts of the short-term debt market.

Technological and Security Concerns: Blockchain technology is relatively new. Its associated risks may not emerge until it is widely used. Blockchain systems could be vulnerable to fraud, particularly if a group of participants colluded to defraud the rest. Several competing public blockchain platforms may present competing intellectual property claims. Despite enhanced security features, blockchain is not immune to cybersecurity threats.

Adoption and Integration: The widespread adoption of tokenized MMFs will require infrastructure changes at many institutions. Extensive education and training may be needed for stakeholders to understand and adopt the technology. The transition may be costly and time-consuming. Integrating blockchain technology with existing systems can be a daunting task. There may be resistance to adopting technological changes from within an organization.

Conclusion and Future Potentials

The tokenization of money market funds represents a significant advancement in institutional cash management, offering enhanced liquidity, improved transparency, and operational efficiency. As this technology continues to evolve, it has the potential to reshape how institutions manage their cash resources. The successful integration of tokenized MMFs will require careful consideration of regulatory developments and market dynamics.

Tokenized MMFs can mark the beginning of greater innovation in institutional cash management strategies that enable the creation of customized investment products tailored to the specific needs of cash investors. While the future holds promise, the elimination or reduced reliance on intermediaries may invite fierce pushbacks and lobbying efforts against greater adoption. Like all new products, tokenized financial products may not garner sufficient market acceptance and achieve a critical scale to be a lasting cash management solution.

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