

## Valitas Insights: Blockchain and M&A

### Part III – The Delaware Blockchain Initiative – Autonomous Digital Markets

When we published [Part I](#) of the Blockchain and M&A series in early October, Bitcoin had begun to garner some [mainstream attention](#). We emphasized in the article that we were not looking to discuss cryptocurrencies, but rather shed light on how blockchain technology could improve the M&A process. We covered a general introduction to blockchain and how a “smart contract” on the blockchain translates to systematic contractual outcomes rather than trust-based outcomes.

By the time we wrote [Part II](#) of the series in late November, the [general public](#) was starting to take a look behind the curtains and unveil the significance of blockchain. We covered how blockchain could improve three aspects of the M&A process: due diligence & compliance, cross-border payment systems, and confidentiality.

Now, writing Part III of the Blockchain and M&A series, it seems that [just about everyone](#)<sup>1</sup> has a definitive “expert” opinion on cryptocurrencies and an understanding of blockchains and the significance of a distributed ledger... well, that was quick!

In Part III, the series finale, we will explore the widespread M&A implications of the “Delaware Blockchain Initiative” and touch upon the newly announced Canadian equivalent.

#### **The Delaware Blockchain Initiative**

On April 5<sup>th</sup>, 2016, Jack Markell, the 73<sup>rd</sup> Governor of Delaware, [unveiled an ambitious initiative](#) aimed at “creating the opportunity for a broad range of corporations – from Fortune 500 companies to startups – to take advantage of distributed ledger and smart contract applications.” Jack called this the “Delaware Blockchain Initiative” and its purpose was to set a foundation for “a more modern, secure and transparent business environment for years to come.”

Jack’s grand vision was to re-engineer the framework behind public company trading and disclosures, an \$11 trillion industry<sup>2</sup>. The significance of this revolution occurring from within the state of Delaware cannot be understated; 61.4% of S&P 500 companies are incorporated in Delaware<sup>3</sup>.

So, what does a more “secure and transparent business environment” look like in reality? The best way to describe this would be with a real-world example. After digging around, I was directed to a Bloomberg article titled, [Fixing the Stock Market’s “Clogged Toilet” Starts in Delaware](#).

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<sup>1</sup> The rationale behind comparing the rise in bitcoin’s search popularity to “Trump”, is because I felt that the search term “Trump” could act as a proxy for “the general public”.

<sup>2</sup> <http://www.dtcc.com/news/2017/january/09/dtcc-selects-ibm-axoni-and-r3-to-develop-dtccs-distributed-ledger-solution>

<sup>3</sup> CapIQ search through public company disclosures.

The article describes the difficulties in identifying share ownership during the 2013 take-private buyout of Dole Food Co. Long story short, investors sued Dole’s founder for illegally driving the share price down prior to the take-private.

When it came time to distribute the \$170 million settlement to shareholders, there was a significant discrepancy between the number of “authorized shares” and the number of shares qualifying for payment. Specifically, there were 49 million shares that qualified for payment of the settlement but only 37 million of those shares appeared on the company’s books!

After a thorough investigation, the Depository Trust & Clearing Corporation<sup>4</sup> (D.T.C.C.) admitted that it was too difficult to accurately identify who held settlement-qualified shares. A [NY Times article](#) summed the situation up by stating “The Dole settlement highlights that as our capital markets become ever more complex, share trading and ownership are getting harder to track.”

The Dole Foods example distinctly identifies some of the issues with the current system, and this has not gone unnoticed by the D.T.C.C. In fact, in light of the Delaware Blockchain Initiative and the D.T.C.C.’s “clogged toilet”<sup>5</sup> of clearing and settling trades, the D.T.C.C. has laid out an ambitious blockchain solution. Before explaining their solution, it is important to understand how trades are currently settled behind the scenes. The image below<sup>6</sup> sums it up pretty well—essentially, everything flows through the D.T.C.<sup>7</sup>



<sup>4</sup> The [D.T.C.C.](#) “stand[s] at the center of securities trading activity, processing more than 100 million financial transactions every day [...]serv[ing] as the centralized clearinghouse for more than 50 exchanges and equity platforms, maintaining multiple data and operating centers worldwide.”

<sup>5</sup> According to [Bloomberg](#), the Dole Foods case highlights the need to fix the stock market’s “Clogged Toilet”

<sup>6</sup> Link to a [40-page PDF](#) issued by the D.T.C.C to explain their role in financial markets

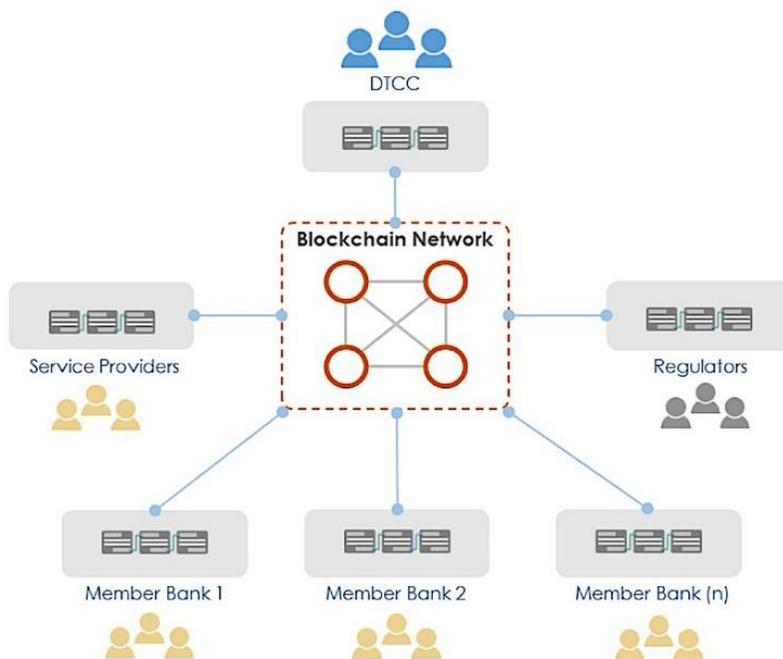
<sup>7</sup> Subsidiary of the D.T.C.C.

In the current system, contrary to popular belief, public market stockholders do not technically own any stock. Technically, public stock is merely an “IOU” written by [Cede & Co.](#), who has a partnership with the D.T.C.<sup>8</sup>

So, what’s this big announcement? Well, the D.T.C.C. is planning to implement a blockchain solution to replace aspects of its current system. The [New York Times](#), the [Wall Street Journal](#), and the [Financial Times](#), each penned articles explaining how the D.T.C.C.’s announcement would alter the future of the financial ecosystem.

Michael Bodson, Chief Executive of the D.T.C.C. suggests that a distributed ledger provides “one version of the truth that everyone shares and everyone utilizes.” In fact, with a blockchain solution, the D.T.C.C. could effectively streamline the entire trading and settlement operation with complete transparency and accuracy.

IBM is working closely with the D.T.C.C. to implement a blockchain solution for derivative trade clearing. Shanker Tamamurthy, General Manager, Strategy & Market Development at IBM [described a new system](#) as “replacing the decade-old Trade Information Warehouse<sup>9</sup> platform with new Distributed Ledger Technology [...] creating a robust resilient solution that guarantees identical copies of data across multiple nodes. [...] All industry participants will have access to data on the distributed ledger, eliminating the need for reconciliation and [...] reducing infrastructure cost.” [Visually](#), here is how IBM describes what the future might look like for settling trades:



This illustrative system is the epitome of Michael Bodson’s vision of “one version of the truth that everyone shares and everyone utilizes.” The cost savings for all parties leveraging the blockchain network would be tremendous, although, no specific dollar estimates are available. We can be certain of one thing at least: no more Dole Foods mix-ups.

<sup>8</sup> <https://www.americanbanker.com/news/you-dont-really-own-your-securities-can-blockchains-fix-that>

<sup>9</sup> [Information Warehouse](#) is the D.T.C.C.’s database responsible for storing derivative trade settlement data

In Canada, we are making strides in the space as well. In February 2018, [the CSE announced](#) that they would be introducing a blockchain platform for trading, clearing, and settling tokenized securities. While they don't yet have a cool name like the Delaware Blockchain Initiative, they have a [cool website](#) which describes the benefits of this not-too-distant future project.

The implications on the M&A industry stemming from the Delaware Blockchain Initiative and CSE's announcement are abundant. For starters, due diligence on share ownership would be less complex and costly. Secondly, the cost and complexity of executing an M&A transaction in the public markets would be reduced, which could open the floodgates for an increase in smaller M&A transactions. One of the major gating items for a larger company to acquire a smaller company is the cost alone. For example, if a \$1 billion Enterprise Value (EV) company is looking to acquire a \$5 million EV company, the larger EV company could incur upwards of \$1 million in legal and advisory fees.

The implied cost savings and process efficiencies are somewhat obvious and relatively standard for any disruptive technology. It becomes incredibly exciting, however, when Michael Bodson alludes to a paradigm shift. He explained in a [NY Times article](#): "if the database was successful, the D.T.C.C. could use the technology to move money rather than just record information."

Imagine a financial system where records are not kept *about* transactions, but rather, the transaction itself *is* the record. This is a groundbreaking concept:

*If ownership records and money move in one combined and instant transaction, the definition of "money" as we know it could drastically change.*

How much of a difference would it be for the D.T.C.C. to throw in tokenized, previously illiquid, hard assets to the mix? For instance, what if the real estate "tokens" flowed through the D.T.C.C.? Could these digital "tokens" then be used for payment if the record keeping system is completely automated?

How about art "tokens" or even any of [these weird collectibles](#)? Could the world adapt to a public marketplace where a piece of real estate or a piece of a Van Gogh was accepted at the grocery store, in the same fashion as currency? Who knows...

Regardless, we are amid a blockchain revolution. Professionals within the deal community must, at a minimum, *understand* what the future of M&A may look like. The choice between embracing or rejecting innovation will be the difference between industry leaders and the rest of the pack. What are *you* doing to prepare?