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# Talking Investment Management: Tokenization and Stablecoins: What Fund Managers Need to Know

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**Jamie Gershkow (00:03):**
Hello and welcome back to the Talking Investment Management Podcast. I'm Jamie Gershkow, a partner here at Stradley Ronon, and I'm excited to be joined by my colleague and partner, Jesse Kanach.

**Jesse Kanach (00:13):**
Hello, and Jamie, thanks for having me. I'm looking forward to our discussion today.

**Jamie Gershkow (00:17):**
As am I. Today's episode, we'll discuss the rise of tokenization, which has gained significant traction in the asset management industry. Whether you're a Fintech enthusiast or just trying to keep pace with the regulatory landscape, we invite listeners of all backgrounds to tune in to why this topic matters now and where we're potentially headed down the road. Jesse, let's start with the basics. When we say tokenization, can you break down what we mean and why tokenization is gaining momentum?

**Jesse Kanach (00:45):**
Absolutely. As a fund formation and regulatory lawyer, every day I focus on better structures for investors to hold directly or indirectly assets. And starting way, way back, we've seen the evolution of holding assets physically like the old school treasure chest or the safe or the bank vault. Then over time, evidenced on paper like those embossed stock certificates that were passed around for hundreds of years up through the 1960s on into the computer age, the book entry, electronic books and records that we all looked to online now and next you'll see blockchain and cryptographic developments often referred to as tokenization, where the evidence of ownership and transfer of your asset through near instantaneous unforgeable, self-verifiable mechanisms with your remaining and change holdings updated right away. So now, tokens are more than just an update of paper or electronic record keeping. They can actually make unnecessary some of the redundancies that the current clunkier system has found necessary to build in for whether wiring funds or settling stock transactions or setting up escrow to make sure the other side to the transaction does its part.

**Jesse Kanach (01:57):**
I mentioned assets, and there are countless varieties of them and ways to get investment exposure to them. But one of these assets that's of critical importance to the US and even global markets is the US dollar, specifically either a $1 bill or an instrument that represents a $1 unit. So now it's been over four decades since $1 per share money market mutual funds were developed in the us, followed by some hefty regulation for good reason. So now I know I need to turn here to Jamie. You counsel study money market funds. You're at the forefront of the regulatory developments impacting them, and now we've seen an uptick in interest around tokenized money market funds. What about the way these products are structured, which makes them attractive for tokenization?

**Jamie Gershkow (02:42):**
Sure, thanks, Jesse, for that. So let's talk first about traditional money market funds. These are funds that invest in high-quality short-term debt instruments and, more specifically, the large majority of us registered money market funds are government money market funds, which allows them to use theoretical cost method evaluation to maintain a stable dollar per share. These funds are popular cash management vehicles for a variety of reasons, including the stability of the $1 price per share while being able to earn some yield on your cash. In the meantime, all within a fund wrapper that is generally considered fairly low risk tokenized money market funds or tokenized share classes of money market funds, take that product and all of those features and benefits and essentially put it in a different file format whereby fund shares and, and investors ownership in the funds are represented by digital tokens on blockchain networks.

**Jamie Gershkow (03:38):**
So, put another way, these are your traditional money market funds that have digitized fund ownership on different blockchain networks. The underlying assets held by the money fund don't differ from traditional money market funds, meaning these aren't the types of funds that are investing in crypto or anything like that. It is just that the digitized fund ownership is on different blockchain networks. So why money market funds for tokenization? I think these give investors a way to access the benefits of money market funds. Coupled with the advantages and efficiencies of blockchain technology, they retain the low-risk benefits of a traditional money market fund with some really interesting use cases as cash management vehicles. We've seen different varieties of these products with different features that continue to evolve and innovate. One of these interesting features, for example, is peer-to-peer transfer, which is the ability to transfer fund shares from one shareholder wallet to another shareholder wallet within or between different approved blockchain networks.

**Jamie Gershkow (04:43):**
So, as an oversimplified example, Jesse, you and I have wallets on approved blockchain networks. I could transfer my money market fund shares to your wallet, processed immediately at any time on any day. Tokenization and the use of blockchain have also allowed for the development of methods to distribute intraday yield based on the period of time each person holds transferred shares during an NAV cycle. So in my example, Jesse, you would effectively begin accruing income dividends immediately upon transfer.

These dividend distribution calculations have the ability to take into account any number of transfers between any number of participants during an NAV cycle. This all comes alongside the more general rise in decentralized finance, including stablecoins, for example. So now that we've discussed money market funds, let's shift over to stablecoins. Many have probably seen that stablecoin legislation is pending in Congress, and some have compared stablecoins to tokenized money market funds, but there are distinct differences. Jesse, can you again take us back to basics here and explain what a stable point is and how these are different from the tokenized money market funds we just discussed?

**Jesse Kanach (05:56):**
Well, a stablecoin is a transferable token that represents a value of $1 or some other number. I'll just talk about $1 for this purpose; they're meant for token transactions or other instant digital transactions, basically, payments of some kind. They can be extremely efficient. And using a $1 coin rather than volatile Bitcoin or ether, for example, can be reassuring by comparison. Wiring money is a bit like sort of printing an email that you receive and then mailing it back in an envelope. It does a job, but it's a lot less efficient. It doesn't track your records of having sent it. There's less assurance that the transaction has gone through or less immediacy. So that said, the efficiency of the transfer, which is indisputable, must be looked at alongside the question of why is the stablecoin worth a dollar?

**Jesse Kanach (06:53):**
The stablecoin can say it is a community can agree it is, but something needs to back it. And Jamie, you discussed regulated money market funds, which are backed by specific types of assets. There really is a tried and true methodology to maintaining a $1 price. The regulators and the markets have really tested this through many stress test-type market events. But based on all the lessons learned, it's way more complicated than, for example, just live streaming a shelf full of cash to prove the backing is there. Now, even assuming the stablecoins, the $1 value will be respected perpetually. Why place your hard-earned assets in a stablecoin? And remember, it's for transferability only. You certainly don't wanna hold them as an investment. The thing to remember about cash in hand is that a $1 bill does not maintain value. It loses value in sync with inflation.

**Jesse Kanach (07:47):**
And I mean, every financial institution puts its cash to work. ASAP, you hear about sweeping cash into interest-bearing accounts each day or at the end of each day and parking actual idle cash maybe in your pocketbook, your wallet or a cash register. That's about the only time someone would normally wanna hold idle cash. And it's not just an interesting practice. There are class action lawsuits in the news as we speak, claiming that money managers didn't sweep their clients' idle cash into high-yielding accounts. So for stable coins, there's not only the risk of holding the $1 asset, there's even a risk of loss and there's so many common circumstances like bankruptcy or nobody wants to accept the token anymore or the technology fails, which we've seen or fraud, which we've seen, or, a country makes the coin illegal even if it wasn't illegal.

**Jesse Kanach (08:40):**

So normally it's the oldest rule in finance that a person looks to be compensated for risk, even quote unquote safe. US treasuries have to pay interest to attract someone to provide the US government with money. So, transacting with stablecoin sounds great. Holding them for long term, not so much. Now, Jamie, you mentioned legislation and coming down the pike, legislation intended to foster the use of stablecoins has a lot of momentum. A chief aspect is that certain permitted stablecoins with certain kinds of backing will be defined not to be a security for purposes of the federal securities laws. The Securities and Exchange Commission, the SEC who I focus a lot on because as a private funds lawyer, many SEC issues arise. The SEC would not impose its longstanding disclosure, market structure, or anti-fraud rules at all. Instead, generally, banking regulators would be stepping in.

**Jesse Kanach (09:34):**
Keep in mind these have a bit of a different focus, as the soundness of the banking system can be more important than small-scale consumer protection. And the disclosure regime is different from the SECs as well. So once the legislation and rules take effect, on the one hand, we can expect the role of stablecoins for payments to really surge. But that said, I'll mention that the legislation may be at odds with the newish concept of interest-bearing stablecoins since the permitted activities under the legislation or at least some of the legislation, are very narrowly defined. So keep your eyes open for developments for those. And Jamie, you may have thoughts on interest-bearing stablecoins in general.

**Jamie Gershkow (10:12):**
Yeah, it's an interesting development in the stablecoin space is the development of an interest-bearing stablecoin in the form of a face amount certificate. Face amount certificates are relatively obscure structure. This is the first one in over a quarter of a century. These are debt securities that offer interest on principle that are issued and redeemed using blockchain technology, which will also be transferable on the blockchain in peer-to-peer transactions. So, very interesting development in a very older wrapper that we really haven't seen in quite some time. As these products continue to gain market momentum, the legal compliance and regulatory landscape becomes increasingly important. So let's dive in and talk about some of these regulatory considerations. One thing I'll note generally when I say money market funds in this discussion is that we've been talking about US money market funds registered under the 1940 Act. Speaker 1: (11:08)
However, there are a handful of other liquidity vehicles that have been tokenized that are colloquially referred to as money market funds, but may not necessarily refer to us registered money market funds and are instead private liquidity pools not registered under the 40 ACT that are limited to being offered to certain types of institutional qualified investors.

**Jamie Gershkow (11:47):**
A tokenized fund is an SEC registered mutual funds registered under all of the same rules that exist in the US sold by prospectus. So, these tokenized products go through the regular SEC registration process that your more traditional mutual funds or money market funds would go through. But of course, there are special considerations to think through here. For example, does the issuance of tokens result in the issuance of separate securities? What happens if there's an outage on a blockchain that could impact the fund

and its ability to meet redemptions? Are there any novel features of the funds that may require no-action relief or exemptive relief from the SEC? Are there different or enhanced KYC or a ML procedures that are appropriate? These are some of the things that we've been thinking through as these products come to market.

**Jesse Kanach (12:37):**
You know, that's an interesting transition to how these registered funds, SEC registered 1940 x funds, operate as exchange-traded funds, or ETFs, in a normal stablecoin. Maintaining a $1 price could be tough, but if there was an ETF that that intended to maintain a stable price, there is a by now longstanding mechanism for arbitraging through creation and redemption of the ETF shares with authorized participants that are generally large investment banks, dealers and other large institutional parties, that really maintain, for many ETFs, the net asset value and for these funds could maintain a $1 stable value. The funds that don't operate in the US as full-fledged ETFs may have additional challenges in maintaining the $1 price. Stablecoins that really seek to operate as non-funds and as non-issuers of securities also have additional issues to consider.

**Jesse Kanach (13:48):**
A know your customer, a ML anti-money laundering considerations. For example, if stablecoins used for payment are considered money for certain purposes, are they money services businesses? Are they, do they, are they subject to money transmitter regulations? There are federal and state overlapping rules that can come into play. So you've got anti-money laundering, anti-terrorist financing, sanctions, and regulations that can all make the stablecoin area a bit risky from a compliance standpoint, not just for the issuer, but even for a user, especially one who accepts stablecoins in large amounts. And the policy behind that is that when a dollar or large amount of dollars is transmitted through the US banking system, through broker dealers and through commodity futures trading commission, CFTC registrants, everyone involved has some assurance that anti-money laundering processes are in place. But if a stable coin can be transmitted across the world as if it's an anonymous suitcase full of cash, that's not looked upon kindly.

**Jesse Kanach (14:48):**
So you will see a lot of measures implemented to stop that in the non-securities stablecoin context. And I thought I'd say, given all the extreme innovation we're seeing with real momentum resilience, Jamie, I'd like us to discuss where we think we're headed with regard to tokenized assets and where we see the space evolving. I could kick it off, or I'm happy to turn it over to you. Take us away, Jesse. Great. Well, what I see we might be working toward is a convergence of two work streams. First, the stablecoin and all of its amazing innovations to allow a dollar token for token transactions. Second, the money market fund ETF, with all of its amazing innovation to allow a dollar share transfer to a recipient transaction, if you build out the securities market structure chassis, that is a token adaptive infrastructure that solves for why the existing elements were in place decades ago.

**Jesse Kanach (15:44):**
You can work through a tried and true diagram and remove and replace some of the elements. The clearing agency, the securities exchange, the transfer agent, the carrying and introducing broker, the good control location, the uniform commercial code,

infrastructure of the securities account and the security entitlements, the UCC transfers payment and settlement rules. And then you've got the investor protections that know your customer, the soundest and integrity of the market, capital formation competition, regulatory transparency, on top of all that day-to-day unforeseeable hiccups, which actually have been foreseen accounting for fat finger errors, as they call them, the lost securities, the deceased, the bankrupt, the gift giver. All these market solutions are mature in the current structure. The players know that tokens are coming and they're ready, ready to further innovate with the tokenization of transferable securities. So if you batch together these innovations, and that's where the magic happens, you produce a tokenized money market fund, ETF, that could be used for everything from being collateral for derivatives transactions to a coin for digital payments.

**Jesse Kanach (16:53):**
So that with a pressable button, the retail customer shows up at the counter, pays for their shopping cart at a participating broker-dealer terminal attached to the cash register just like today's credit card terminal and the beauty of it is, as Jamie was mentioning, with respect to tokenized money market funds, the customer receives interest and dividends until the moment of the transaction. The retailer begins receiving the same a moment later. So, there is no idle cash, which is a real downside of a $1 idle cash instrument. The customer retailer have been vetted for anti-money laundering, suitability the unbanked can participate since this is just a different scope than a bank account holders are protected by the federal securities laws. Their interest payments are efficiently taxed. And importantly, the transactions don't draw money out of the money market fund. So transaction costs of buying and selling underlying assets are eliminated, and there's less stress in the mechanics underlying the financial system, just fewer moving parts. And Jamie, that's where I see all this going.

**Jamie Gershkow (17:53):**
Yeah, and I just add, I know broadly speaking, I think this is only picking up more momentum, and we're seeing the world of traditional finance and decentralized finance converge. And I think we're gonna continue to see increased tokenization of real-world assets, generally not just money market funds, but further democratizing access to these assets, more broadly speaking. Jesse, any final thoughts for us?

**Jesse Kanach (18:18):**
Well, I would just like to say that in my private funds practice, anyone can invest in anything. Many invest in digital assets. And now that the asset class is maturing and can really take wing, I say let's structure a better way to do that. Stablecoins or, better yet, tokenized money market fund ETFs or the next big thing. Each of these is a super innovative path to get there.

**Jamie Gershkow (18:41):**
Well, that's it for today's discussion on tokenized products. If you'd like to learn more, connect with us, our contact info is included in a description of the podcast. And please be sure to visit our newly updated and refreshed website to learn more about all the services that we offer, from funds to FinTech and so much more. Thanks for joining us today.

**Jesse Kanach (19:00):**
And thanks again for asking me to join Jamie.

**(19:06):**
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**For more information, contact:**


Jamie M. Gershkow
Partner
212.404.0654
jgershkow@stradley.com



Jesse P. Kanach
Partner
202.292.4528
jkanach@stradley.com