BRIEFINGNOTE

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Tokenisation – not a token development

Tokenisation of investment funds, as its name suggests, refers to the issuance of shares or interests in an investment fund by way of tokens, a form of digital representation on distributed ledgers like a blockchain. While not a new product, tokenisation represents a part of the next evolution of finance where things, like life in general, are just speeding up.

Its benefits are plenty: shorter settlement time, 24/7 trading, system automation via smart contracts, enhanced transparency and compliance, better auditability, so on and so forth. Let's take a look at how tokenisation is evolving in two key Asian financial markets where regulators are progressively recognising its potential for both growth and risk.

Hong Kong

An increasing number of fund managers are exploring tokenisation of investment funds. Aptly, the city's Securities and Futures Commission ("**SFC**") has released, relevant guidance in two circulars published 2 November 2023: one on the tokenisation of securities-related activities (the "**Securities-related Activities Circular**"), and the other on the tokenisation of SFC-authorised investment products (the "**Authorised Product Circular**").

The progressive approach sees the regulator pivot to categorising tokenised securities as traditional securities with a tokenisation wrapper; previously (in a note published 29 March 2019) it regarded them as "complex products" that required additional investor protection measures and only availed them to professional investors. That has been specifically superseded by the latest circulars. The complexity of tokenised securities is now assessed by the underlying assets pursuant to the existing regulations and the professional investor restriction is no longer in force.

It is also worth noting that the SFC excluded tokenised securities from the "de minimis threshold" set out in the Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets.

One of the known benefits of tokenisation of investment funds and other securities is democratisation of access, which allows an asset to be fractionalised which in turn improves liquidity. But this is not without risk and the SFC rightly provides in its Authorised Product Circular that to protect retail investor interest, the secondary trading of tokenised SFC-authorised retail investment products need to comply with certain criteria including the maintaining of proper and instant token ownership record; readiness of the trading infrastructure and market participants to support liquidity; and fair pricing of the tokenised products.
While the criteria are meant to apply to SFC-authorised investment products, it is ultimately imperative for tokenised product providers, whether the products are authorised or not, to demonstrate to the SFC management and operational soundness, clear disclosures, record keeping of ownership and integrity of the smart contracts.

For more detailed information on Hong Kong virtual assets regulations, please read our November Briefing Note on "Virtual Asset Regulation November update – the retail market and tokenisation".

Singapore

Similarly in the Lion City, in response to strong interest from the funds industry, the Monetary Authority of Singapore ("**MAS**") launched on 15 November 2023, a new funds workstream within its Project Guardian initiative, which explores the use of blockchain in institutional virtual assets trading. This new area looks into the native issuance of Variable Capital Company funds on digital asset networks and it aims to scale tokenised markets and increase distribution channels for asset managers while addressing tax, policy and legal considerations. The MAS also plans to work with the Accounting and Corporate Regulatory Authority to better assess opportunities and risks of adopting digitally-native Variable Capital Company fund shares.

Conclusion

The world of tokenised securities and more specifically investment funds are not new. But as it expands in terms of related infrastructure, market maturity, and regulation and industry alignment, such operations may well grow exponentially. Scaling up in this regard is impossible without careful consideration for the evolution of its entire ecosystem, including custody and distribution channels. Watch this space.

We advise clients in the financial sector on matters involving virtual assets and tokenisation regulations. Please get in touch if you are interested in discussing any of the above.

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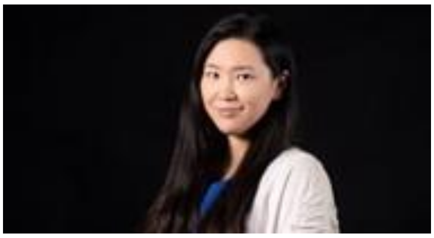

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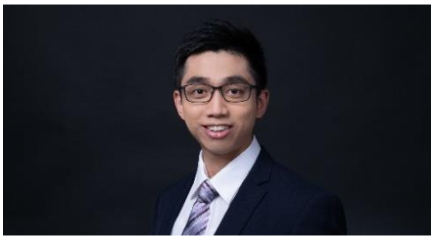

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