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Client Alert

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Quick guide on offering tokenised public funds in Hong Kong

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Digital tokens created to represent ownership in funds are no longer restricted to professional investors. On 2 November 2023, the Securities and Futures Commission (**SFC**) announced it will permit primary dealings of tokenised SFC-authorised investment products by retail investors: a fund must satisfy the applicable product authorisation requirements and be wrapped with a tokenisation arrangement with sufficient risk management safeguards before the fund's units or shares can be offered as digital tokens to the public in Hong Kong. The dealing in, advising on, or management of the tokenised SFC-authorised funds (i.e. the fund tokens) as tokenised securities will need to comply with additional risk management, due diligence and disclosure requirements. For details of the SFC's new guidance, please refer to the SFC's circular on intermediaries engaging in tokenised securities-related activities, and SFC's circular on tokenisation of SFC-authorised investment products.

Below is a quick guide for fund managers on how to tokenise their SFC-authorised funds for offering to Hong Kong retail investors based on the SFC's new guidance.

1. Select the right product

In the context of SFC-authorised investment products, tokenisation refers to the creation of blockchain-based tokens that represent or aim to represent ownership in an investment product. SFC-authorised investment products (including SFC-authorised funds) are "*securities*" as defined under the Securities and Futures Ordinance (**SFO**). Tokenised SFC-authorised investment products are in substance, securities wrapped in a digital format (i.e. a "tokenisation wrapper") and will be continuously governed by the SFC's product authorisation requirements. As such, before a tokenised fund (i.e. a fund being recorded digitally on blockchain) can be offered directly to end investors, or distributed by intermediaries, or traded among the blockchain participants in the retail market, it must satisfy the applicable product authorisation under the SFO.

If a fund manager currently does not have a fund that has already been authorised by the SFC for retail offering in Hong Kong, it should create a new fund and seek the SFC's authorisation for the fund. Prior consultation with the SFC will also be required if a new (tokenised) class of an existing SFC-authorised fund is issued.

2. Construct tokenisation arrangement

Tokenisation generally involves the use of distributed ledger technology (**DLT**) for digital record-keeping with integration of rules and logic governing the transfer process of the assets. For tokenising an SFC-authorised fund, the SFC discourages the use of public-permissionless blockchain networks which lack restrictions to access for privileges and have defining characteristics such as pseudonymity. The SFC disallows tokenised SFC-authorised products being issued in bearer form on such a network. A private-permissioned DLT network characterised by a centralised authority that controls and restricts access to pre-determined users (including the fund manager issuing the tokenised SFC-authorised fund) will be preferred as it enhances security of the tokenisation. The SFC is also open to a public-permissioned DLT network with a centralised authority that controls and restricts access through authentication but will likely request more security comforts.

To meet the SFC's regulatory expectations, the fund manager of a tokenised SFC-authorised fund should include the following control mechanisms in the tokenisation arrangement:

- Product providers (and primarily, the fund manager of the tokenised SFC-authorised fund) should remain ultimately responsible for the management and operational soundness of the tokenisation arrangement adopted and record keeping of ownership, regardless of any outsourcing arrangement.

- Proper records of token holders' ownership interests in the SFC-authorised fund should be maintained; and the tokenisation arrangement should be operationally compatible with the service providers involved.

- Appropriate measures to manage and mitigate cybersecurity risks, data privacy, system outages and recovery as well as a comprehensive and robust business continuity plan should be maintained.

Upon the SFC's request, the fund manager will also need to:

- Demonstrate the management and operational soundness of the tokenisation arrangement as well as integrity and proper adoption of record-keeping of ownership and smart contract technology to the SFC's satisfaction; and

- Provide a legal opinion to support its application covering the legal and regulatory status of the tokenised fund.

3. Determine dealing model and engage services providers

Depending on the dealing model of a tokenised SFC-authorised fund, the fund manager will need to co-operate with different services providers such as the following:

- Tokenisation agent who will provide the tokenisation technology and platform;

- Provider of digital wallets who will house and keep the fund tokens;

- SFC-licensed dealer/virtual asset trading platform operator (subject to its capability and readiness of infrastructure) and/or possibly in the future, the Hong Kong Exchange and Clearing Limited (subject to the development of its retail fund platform), who will deal with subscriptions and redemptions (and in the future, possibly trading) of the fund tokens;

- Auditor or consultant who can audit or verify the technology aspect of the fund tokens, including the smart contracts employed, robustness of the DLT network, interoperability of the DLT network and back-end systems of the product issuer and other services providers, and systems and controls underpinning the token operation; and

- External counsel who will advise the regulatory status of fund tokens, their settlement finality and enforceability of the tokens themselves (including the rights attached or extrinsic to the tokens).

Before engagement, the fund manager should conduct due diligence on the experience and track record of the service providers.

4. Enhance compliance infrastructure

The SFC anticipates new risks arising from tokenisation, in particular, the ownership risks of how ownership interests relating to fund tokens are transferred and recorded, and the related technology risks (e.g. forking, blockchain network outages and cybersecurity risks). The fund manager of a tokenised SFC-authorised fund will be held responsible for the overall operation of the tokenisation arrangement despite its outsourcing arrangement with third-party service providers.

The SFC therefore expects the fund manager to enhance its compliance infrastructure, which include among others:

- Adopting a business continuity plan for the DLT-related events that are not adequately addressed with other measures;

- Implementing measures to address data privacy risks and money laundering and terrorist financing risks associated with the tokenised SFC-authorised funds; and

- Appointing at least one competent staff with relevant experience and expertise to operate and/or supervise the tokenisation arrangement to manage the new risks relating to the ownership and technology appropriately.

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5. Make proper disclosure in the fund's offering documents

The SFC requires disclosures of the tokenisation arrangement, ownership representation of the fund tokens and associated risks with the tokenisation arrangement be included in the fund's offering documents.

As an innovative technology, tokenisation has created a new distribution channel for SFC-authorised funds. Whilst tokenisation may bring new market opportunity to traditional investment products, Hong Kong is at a start-up stage for tokenised investment products and still needs more infrastructural supports to facilitate the operations (and more importantly, circulation) of the tokenised investment products. Before proceeding to a tokenisation route, fund managers should conduct a thorough cost-and-benefit analysis by taking into account various factors, for example:

- its business goals;
- its resources (e.g. human, technology and compliance resources);
- distribution options and costs (e.g. options and costs of the existing distribution channel vs. tokenisation); and
- evolving regulatory landscape and market infrastructure.

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