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December 5, 2023

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UK Fund Tokenization: A Greenlight and Blueprint for Implementation

On 24 November 2023, the industry-led Technology Working Group of HM Treasury's Asset Management Taskforce (Group) released an interim report (Report) outlining a strategic blueprint for the implementation of fund tokenisation in the UK.

This development occurs amid the broader initiative by the UK regulatory bodies to harness the potential of technological advances, including blockchain and distributed ledger technology (DLT), to bolster the UK asset management industry. HM Treasury and the Financial Conduct Authority (FCA) serve as observers on the Group and endorsed the Report. The Report recommends a staged approach to fund tokenisation, starting with a baseline model compatible with the existing legal and regulatory framework.

Tokenised Funds

While not formally defined, "tokenised funds" generally refer to funds issuing tokenised shares or units, which represent an investor's interest in a fund, and which are traded and recorded using DLT, such as a blockchain enabled by smart contracts, rather than a more traditional record-keeping system.

To avoid confusion, the Report explicitly states that tokenisation at the fund level simply seeks to leverage the benefits of the underlying technology of DLT and does not automatically provide exposure to cryptocurrencies, NFTs and other cryptoassets, as these assets should be treated with more caution given their risk and volatility features.

Fund tokenisation has attracted interest in the asset management sector because of a full set of promised and potential benefits, including:

- A faster and more efficient record-keeping system.
- A transformed and digitally enabled back-office infrastructure.
- Cost-efficient fund administration, reconciliation and settlement capabilities.
- The ability to scale automated processes for distributions or corporate actions using smart contracts (with customisable taxation and other reporting and compliance functions built in).
- The potential for using tokens as collateral, especially in thinly traded markets.
- Enhanced data transparency and data disclosures.
- Personalisation of portfolios to meet specific investor needs.

Globally, tokenised funds have risen in popularity in a number of jurisdictions, including in the US, Singapore and continental Europe. In April 2023, Polygon blockchain supported the first US-registered mutual fund to use a public blockchain to process transactions and record share ownership. In October 2023, the FCA, alongside other regulators, joined

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Project Guardian, a regulatory project initiated by the Monetary Authority of Singapore in May 2022, to work with global partners and the financial industry to explore fund and asset tokenisation use cases.

Given the size of the UK asset management industry, the Report considers the UK "uniquely positioned" to lead in this area of development and to interact efficiently with the wider international capital markets ecosystem that increasingly focuses on the application of DLT to mainstream asset classes, such as the growing $800 million market in tokenised bonds listed on exchanges in Europe.

Stage One: Baseline Model

The Group identified three registers in the UK funds industry which may be in scope of a fund tokenisation regime, with a long-term vision of each register being accessible "on-chain" to provide synergies across the fund industry and link individual investors and investible assets with a robust, secure, trustworthy and decentralised settlement layer. These are:

- **Client register:** a register of end investors and beneficial owners, for which an investment platform or a distributor is responsible. Potential use cases: creating additional choice for investors when selecting digital fund marketplaces.
- **Unit register:** a register of primary market investors or platforms, for which a fund manager is responsible. Potential use cases: optimising fund inflows and outflows.
- **Asset register:** a register of securities making up a fund's portfolio, for which a custodian or depositary is responsible. Potential use cases: optimising fund administration and potentially opening up new asset classes for investment.

The Group has agreed on a staged approach to implementing fund tokenisation, starting from a baseline model (stage one), which establishes the infrastructure for fund tokenisation. At stage one, the Group has determined to focus on the "unit register", with the "client register" and "asset register" to be phased in later.

The completion of stage one for a selected fund is intended to include the utilisation of DLT for sales and redemptions, but the fund would otherwise function as a mainstream investment fund.

Though firms are expected to develop and pilot their applications of the technology, the Group has identified a few common characteristics of a "stage one" tokenised fund, namely:

1. The fund would be an FCA-authorised fund, established in the UK, and subject to the current regulatory requirements with regards to, including without limitation, an authorised fund manager, depositary and custodian.
2. The fund's investment portfolio would consist of mainstream investment assets, which would be held by a custodian and would not include cryptoassets.
3. The fund would settle transactions in the units of the fund "off-chain" with no use of any forms of digital money, and would need to be compliant with client money requirements.
4. The fund would need to utilise a private and permissioned DLT (not publicly accessible blockchain) to register the units' sales and redemption transactions. The DLT used must be capable of control by the relevant fund manager (*i.e.*, be outside of the consensus mechanism used by most DLT networks).
5. The fund would need to provide valuations on a timescale consistent with existing regulation and market practice (intra-day or real-time valuation excluded at this stage).

Regulatory Greenlight and Challenges

The FCA has reviewed the existing financial regulatory rules, including the Collective Investment Schemes sourcebook, the Investment Funds sourcebook and the Client Assets sourcebook within the set of rules and guidance applicable to the FCA-authorised firms, and identified no significant regulatory hurdles to the stage one baseline model.

The FCA has previously stated that it is open to blockchain networks being used in the operation and administration of collective investment schemes and wants to support firms in implementing technological solutions while addressing risks and potential harms. As the financial watchdog of the asset management industry, the FCA also emphasised that specific implementations may vary from the baseline model, and firms should therefore undertake their own due diligence or seek independent advice on their particular circumstances.

With the FCA giving a greenlight in principle to fund tokenisation, the Group expects that this agreed blueprint will send a clear message to the industry stakeholders that the infrastructure for UK fund tokenisation can be established (currently via the stage one baseline model) and that the industry should reinvigorate its innovation agenda.

Nevertheless, the Group has also identified certain procedural or legal considerations and challenges. One of the notable considerations is the registration process for purposes of the UK's money laundering regulations (MLR): Currently, firms proposing to use DLT for fund tokenisation may be required, on top of their existing FCA authorisation, to register with the FCA as a "cryptoassets exchange provider" or "custodian wallet provider" or both under the MLR, which may present a significant barrier to swift adoption given the time and processes involved, especially for new providers.

In response to this barrier, the FCA is exploring whether a quicker decision-making process for these firms' MLR registration application would be possible. The Report also notes that future stages may require legislative or regulatory amendments, such as some potential updates to the Companies Act 2006 to enable the tokenisation of shares and other corporate securities, or the future stages' compatibility and impacts on the FCA Handbook rules.

A Positive Step Forward

Looking ahead, the Report acknowledges that future stages of fund tokenisation will be shaped by industry feedback, and may also depend on technological developments. The Group has indicated that that it will continue to explore the next possible stages in 2024, including the potential integration of AI, digital money and other innovative technologies.

Despite the potential regulatory or legislative hurdles identified in the Report, the Group's work can be seen as a positive step forward in the integration of new technologies in the UK financial services sector. Of note, the Group has focused on the DLT itself rather than cryptoassets and cryptocurrencies as the assets underlying investment funds.

The next step will be for the UK asset management industry to embrace the opportunity to use these technological advances to improve operational efficiency so that momentum can be maintained.