

# SFC allows retail access to authorised tokenised securities

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## Introduction

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On 2 November 2023, the Securities and Futures Commission ('**SFC**') released 2 circulars in relation to the tokenisation of securities and other investment products, namely (1) Circular on intermediaries engaging in tokenised securities-related activities ('**1<sup>st</sup> Circular**') and (2) Circular on tokenisation of SFC-authorised investment products ('**2<sup>nd</sup> Circular**' together with the 1<sup>st</sup> Circular, the '**Circulars**').

These Circulars represent a bold move by the Hong Kong regulator to formally recognise tokenisation as a financial services tool, and importantly, to open up retail investor access to authorised tokenised securities and investment products in primary markets (subject to the authorisation<sup>1</sup> and prospectus<sup>2</sup> requirements). Previously the SFC's position was that all tokenised securities were 'complex products' that were only available to those meeting the definition of a 'professional investor' ('**PI**'). The SFC is now taking a more risk-based approach and placing more emphasis on the substance of the underlying assets that are being tokenised. For instance, the SFC has made clear that whether a tokenised security is a complex product or not is based on an assessment of the complexity of its underlying traditional security. Obviously, the tokenisation platform and mechanism need to be appropriate, but this change of approach means that some tokenised securities will be available to both PIs and retail clients.

In this news flash, we present the key points that the SFC has raised on the 2<sup>nd</sup> Circular with our views on those requirements and ways in which external assistance could be helpful as appropriate.

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<sup>1</sup> See Part IV of the Securities and Futures Ordinance (Cap. 571) ('**SFO**').

<sup>2</sup> See Companies (Winding up and Miscellaneous Provisions) Ordinance (Cap. 32).

## Circular on tokenisation of SFC-authorised investment products

This Circular sets out the requirements under which the SFC would consider allowing tokenisation of investment products under Part IV of the SFO for offering to the public in Hong Kong.

Area	Key points from SFC circular	PwC view
<b>Requirements for primary dealing of tokenised SFC-authorised investment products</b>	<p>Product Providers (as defined in the 2<sup>nd</sup> Circular) should:</p> <ul style="list-style-type: none"> <li>(a) remain and be ultimately responsible for the management and operational soundness of the tokenisation arrangement adopted and record keeping of ownership, regardless of any outsourcing arrangement;<sup>3</sup></li> <li>(b) ensure that proper records of token holders' ownership interests in the product are maintained and the tokenisation arrangement is operationally compatible with service providers involved;</li> <li>(c) have appropriate measures in place to manage and mitigate cybersecurity risks<sup>3</sup>, data privacy, system outages and recovery, and maintain a comprehensive and robust business continuity plan;</li> <li>(d) not use public-permissionless blockchain networks without additional and proper controls;<sup>4</sup></li> <li>(e) confirm and, upon SFC's request, demonstrate to the SFC's satisfaction the management and operational soundness of the tokenisation arrangement, record keeping of ownership and the integrity of the smart contracts;</li> <li>(f) upon SFC's request, obtain third party audit or verification on the management and operational soundness of the tokenisation arrangement, record keeping of ownership and integrity of the smart contracts; and</li> <li>(g) upon SFC's request, obtain satisfactory legal opinion to support its application.</li> </ul>	<p>The SFC sets out clear guidelines that the issuers of a token are the guardians of the process and will be held accountable for the running of the tokenisation programme for an asset. The SFC makes clear that it is incumbent on the token issuer to design and operate a programme that is secure to internal and external threats. Issuers need to select the DLT platform that is right for them. However, it is clear that public-permissionless blockchains will attract increased scrutiny and should be avoided if possible.</p>
<b>Disclosures</b>	<p>The offering documents of a tokenised SFC-authorised investment product should set out clearly:</p> <ul style="list-style-type: none"> <li>(a) the tokenisation arrangement, particularly, with clear disclosure on whether off-chain or on-chain settlement is final;</li> <li>(b) the ownership representation of the tokens;<sup>5</sup> and</li> <li>(c) the associated risks with the tokenisation arrangement such as cybersecurity, system outages, the possibility of undiscovered technical flaws, evolving regulatory landscape and potential challenges in application of existing laws.</li> </ul>	<p>The disclosure requirements are consistent with the SFC's general expectation that investors should be provided with sufficient information to make informed decisions. Adequate disclosure would also be in the interest of issuers from a risk management perspective. Further, we see these disclosures as being somewhat similar to term sheets/funding arrangement documents and therefore are likely to require, or receive better attention from, a report that includes the verification of a professional firm.</p>
<b>Staff competence</b>	<p>Product Providers should confirm to the SFC that they have at least one competent staff with relevant experience and expertise to operate and/or supervise the tokenisation arrangement and to manage the new risks relating to ownership and technology appropriately.</p>	<p>We believe that there will be a lack of readily available resources within Hong Kong to satisfy the SFC's requirements on having at least one experienced member of staff in tokenisation. Therefore, it will be opportune for professional firms to assist in an advisory capacity.</p>

<sup>3</sup> For example, the actual minting of the token by a technology platform. However, it is uncertain whether this would include the listing/dealing of a token on an exchange, or the provision of liquidity by liquidity providers operating on that exchange. If so, that would appear to vastly increase the risk/liabilities for a tokenised securities issuer/manager.

<sup>4</sup> E.g. Product Providers to impose additional control by using a permissioned token.

<sup>5</sup> E.g. legal and beneficial title of the tokens, ownership of / interests in the product.

<b>Prior consultation or approval</b>	<p>(a) For new investment products that have tokenisation features and plan to seek the SFC's authorisation, prior consultation with the SFC is required.</p> <p>(b) Prior consultation is also required for tokenisation of existing SFC-authorised investment products and such change may require prior approval.<sup>6</sup></p> <p>(c) Given the rapidly evolving nature of the subject, the SFC may provide further guidance or impose additional requirements for tokenised SFC-authorised investment products, where appropriate.</p> <p>(d) If you wish to seek clarification of any aspects of this circular, please contact the relevant case team member of the Investment Products Division.</p>	<p>Prior consultation would facilitate a smooth approval process as any potential issues could be resolved before application submission. The SFC will want to review in detail all aspects of a tokenisation arrangement. We expect that the SFC will want professional service firms' support in providing additional comfort that their tokenisation arrangements are sound.</p>
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### Where you might want to seek external assistance

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If you are an issuer, there are a number of areas you might want to seek external assistance in your tokenisation journey, including support/advice on capital raising and go to market strategy, any specific or associated tax implications, performing an end to end risk assessments and issuance of assurance and attestation opinions over the underlying assets.

For token issuers:

- performing assurance engagements under assurance standards and provide opinion on the design and operating effectiveness of controls
- performing assurance on the design and operation of smart contracts
- reviewing risk and governance arrangements for compliance with the SFC's requirements
- providing legal opinion (if required by the SFC) and support in legal and regulatory compliance
- assisting with the authorisation applications under s104 SFO application (e.g. completing forms, drafting policies, etc).
- performing independent assessment on token issuance and provide a report to the SFC

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<sup>6</sup> For example, prior approval should be obtained before adding the disclosure of new tokenised unit/share class of an SFC-authorised fund in the Hong Kong offering documents and offering it to the public in Hong Kong. No prior approval is required for adding another tokenised unit/share class to the same fund if the tokenisation arrangement is substantially the same as the existing one.

### Final thoughts

The Circulars, while widely anticipated, are still very welcome developments in line with the overall theme of expanding Hong Kong's VA ecosystem - opening up retail access to a small sub-set of VA on SFC licensed exchanges, and now more generally, authorised tokenised securities. However, the opening up of retail access *only* to primary issuances at this stage may disappoint participants who were expecting to be able to tokenise assets and list them for secondary trading.

In any event, expectations around suddenly being able to tokenise anything in the real world and to allow a vast multitude of retail investors to purchase these tokens should be tempered – SFC authorisation is still needed and nothing about that process, including its rigour and compliance standards, has changed for tokenised securities. It will be interesting to see how the market reacts to this development, and what impact it will have on the energy and buzz around the tokenisation movement as a whole. What is clear is that Hong Kong's regulatory framework has kept pace with, and continues to accommodate, trends in the market - and that is great news for all of us working in this space!

### Let's talk

For a deeper discussion of how this impacts your business, please contact us.

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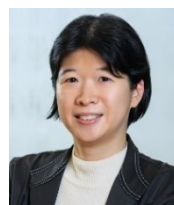
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