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Insights

THE ROAD AHEAD FOR TOKENIZED INVESTMENT FUNDS IN THE UK

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Earlier this year, the technology working group of HM Treasury outlined the initial stages of a strategic road map for the development of a fund tokenization industry in the U.K., with a final phase to be confirmed by the end of 2024.[1]

In anticipation of this final phase, we consider in this article the proposed model for implementation, potential next steps, and wider developments within the digital assets space that would offer greater legal and market certainty to the creation of tokenized investment funds.

Ultimately, the strategic road map forms part of a wider initiative in the U.K. to advance the use of distributed ledger technology, or DLT, and other disruptive technologies within the financial services industry.

DLT-ENABLED TOKENIZED INVESTMENT FUNDS

Tokenized funds are, in essence, investment vehicles that issue digital or so-called tokenized shares representing an investor's interest in that fund, rather than traditional units or shares. Transactions are recorded on a distributed ledger and not on a traditional recordkeeping system. DLT is, in essence, a replicated, shared and synchronized recording system.[2]

This means that tokenized fund providers can potentially link individual investors to assets while operating on a settlement layer that is secure, trustworthy and capable of decentralization. Broadly speaking, we see the following advantages available to investors and fund administrators.

Simplified and Real-Time Recordkeeping

Records maintained via DLT update in real time and are held by all participants, removing the need for a central administrator to supervise or oversee the process.

Quicker Settlement

Open-ended funds generally settle unit transfers in a fund on a T+3 basis[3] and underlying asset transfers on a T+2 basis. The misalignment is deliberate and intended to provide the fund manager with sufficient time to sell underlying assets and to raise cash in order to match any unit redemptions. By contrast, funds that operate on DLT can achieve settlement on a near-instantaneous basis, which potentially reduces credit and settlement risk.

Enhanced Scaling

Funds that use smart contracts can automate distributions of capital, corporate actions or customized reporting based on instructions from investors. These predefined parameters can be ported over to other funds, which allows newly established funds to be investor ready.

Investor Transparency

Relevant investor information, particularly with respect to ownership of fund interests, can be embedded into each token. This could include information on class rights, voting history and any anti-money laundering checks conducted as part of onboarding. These details could be made available to the relevant regulators, which in turn enhances market supervision.

Fund tokenization is not a novel concept and has already emerged in other jurisdictions. As an example, in the U.S., investment manager Hamilton Lane has made a number of tokenized funds available, including its $2.1 billion flagship direct equity fund on the polygon blockchain network.

In continental Europe, Metzler Asset Management has issued tokens in its German-domiciled sustainable growth fund, while Generali Group's fund range in France is available on a DLT-enabled platform.

Elsewhere, UBS AG has confirmed that it is pilot-testing the operation of a money market fund on a public blockchain in Singapore. Clearly, there is increasing activity in other jurisdictions, which reflects an opportunity for the U.K. market.

ROAD MAP FOR IMPLEMENTATION

Baseline Model

The working group has set out a multistaged approach in order to implement fund tokenization. The first stage, which the working group has termed the stage one baseline model, would involve creating and facilitating funds with the following characteristics:

- Regulation: Funds under the baseline model would need to be authorized by the Financial Conduct Authority and established in the U.K., and would need to operate in line with existing legal and regulatory requirements.
- Investment mix: Despite incorporating DLT, funds would be restricted from purchasing digital assets or cryptocurrency. Instead, portfolios would comprise traditional assets, such as stocks and bonds, which is consistent with existing industry norms.
- Off-chain settlement: Transactions would be settled in the usual way with purchases, transfers and redemptions handled by a manager. Settlement would not occur on-chain.
- Recordkeeping: Traditional recordkeeping systems and registers would be replaced with private and permissioned distributed ledgers. As a matter of governance, the fund itself would need to retain some degree of central control outside of the usual consensus mechanism.
- Private access: Use of the fund network would be closed to the public and would be restricted to identified and onboarded participants only. Accordingly, selective data sharing and read-write permissions would be implemented since otherwise participants have shared visibility of the register and its contents.
- Valuations: In line with investor expectations and market standards, tokenized funds would still be required to provide regular valuations of fund interests.

Despite the progressiveness of the baseline model, funds would still be highly recognizable and in line with models already seen in the market.

Future Developments

The working group expects subsequent stages of development to build out or modify characteristics previously contemplated in the baseline model. Further stages will be needed to pilot and progress features incrementally. Future points of development include:

- Tokenized investments: Fund investors should eventually have access to tokenized investments across all asset classes. Accordingly, further technological development will be needed to harmonize trading infrastructure between the buy side and sell side so that all transactions can be effected on-chain.
- On-chain settlement: Transactions under the baseline model settle offline with purchases, transfers and fund redemptions handled in the usual way. On-chain settlement would be explored as a next step so that transfer of title and payment would occur simultaneously within the same infrastructure. This improves the speed of operations and possibly opens the door to integrating digital money into the wider financial system.

- Hybrid networks: Fully public networks provide greater potential for scale, and therefore liquidity, as well as new models for governance. However, the working group expects various elements of control, including an onboarding process to verify users based on anti-money laundering, know-your-customer and product suitability procedures.

THE WIDER LANDSCAPE

The working group's view is that current regulation — including those contained in COLL, the collective investment schemes handbook; CASS, the client assets handbook, and FUND, the investment funds handbook — are wide enough to capture funds developed under the baseline model. As an example, funds carrying out regulated activities, such as custody of tokenized assets probably fall under CASS.

However, further market developments, including those in subsequent stages, are very likely to require corresponding changes to prevailing regulation. Accordingly, markets will require greater legal certainty and wider technology adoption, including that of DLT. There are two recent developments that offer clarity.

One development to leverage is HM Treasury's implementation of the Digital Securities Sandbox, which enables firms to test new technologies, including DLT, under a modified legislative framework. More broadly, the sandbox facilitates the trading and settlement of mainstream assets within a tokenized fund structure.

Various issues still need addressing, including for example, requirements concerning the register of members, instruments of transfer, and the composition of company records. Nevertheless, we see potential opportunities for industry participants to work with regulators and policymakers to clarify the law regarding the ability of funds to hold digital assets and to drive necessary legislative change through the sandbox.

In another development, the Law Commission in July published a supplemental report and draft legislation that, if implemented, would formally confirm the existence of a third category of personal property. The obvious effect of this is to statutorily confirm that personal property exists outside the current two-category model. However, the wider effect is that it opens the door for rights to attach to digital assets — including tokenized funds — which often do not fit squarely within traditional concepts.

Holders of digital assets would benefit from a clearer conceptual basis for any proprietary rights, including where those digital assets were ever the subject of a legal dispute, or lost or destroyed

The HM Treasury technology working group recognizes that effective implementation of fund tokenization will depend on industry uptake as well as broader technological developments. The working group has expressed interest in issuing native digital government bonds with the support of HM Treasury and the debt management office.

This could encourage private market participation and experimentation with tokenized assets. Concurrently, legislation confirming favorable tax treatment of tokens, perhaps in the form of individual savings account eligibility, could also drive investor interest and broader adoption. Ultimately, the latest fund tokenization framework is yet another step forward by the U.K. to enhance its financial market infrastructure.

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FOOTNOTES

[1] https://www.theia.org/sites/default/files/2024-03/Further%20Fund%20Tokenisation%20-%20Achieving%20IF3%20Through%20Collaboration%20%20Mar24.pdf.

[2] Andrew Tsang, 'Money Laundering and Distributed Ledger Technology in Hong Kong' (2017) 48(2) HKLJ 577, 579.

[3] "T" refers to the transaction date while "3" refers to the number of days needed to settle the transaction. Most securities transactions are conducted on a T+2 or T+3 basis, but this may change with the incorporation of DLT.

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MEET THE TEAM

Tom Bacon

London

tom.bacon@bclplaw.com
+44 (0) 20 3400 3706

Andrew Tsang

London

andrew.tsang@bclplaw.com
+44 (0) 20 3400 3652
