SFC issues updated guidance on tokenised securities-related activities and tokenisation of SFC-authorised investment products

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The SFC issued the Circular on intermediaries engaging in tokenised securities-related activities (the “Intermediaries Circular”) and the Circular on tokenisation of SFC-authorised investment products (the “Product Circular”, together with the Intermediaries Circular, the “Circulars”). The Circulars provide colour on the SFC’s updated expectations on intermediaries who engage in tokenised securities-related activities and product providers of tokenised SFC-authorised investment products.

Key Takeaways

1. Who do the Circulars apply to?
   - The Intermediaries Circular applies to licensed intermediaries engaging in tokenised securities-related activities.
   - The Product Circular applies to product providers of tokenised SFC-authorised investment products, which are authorised under Part IV of the Securities and Futures Ordinance for offering to the public in Hong Kong.

2. What products are relevant?
   - **Tokenised securities**: these are a subset of digital securities that are traditional financial instruments which fall under the Securities and Futures Ordinance (“SFO”) definition of “securities”, and which utilise DLT or similar technology in their security lifecycle.
   - **Digital securities**: “securities” as defined under the SFO that utilise DLT or similar technology in their security lifecycle. Digital securities can range from “securities” that are more akin to traditional financial instruments to those that are structured in more bespoke, novel or complicated forms, with some existing exclusively on a DLT-based network with no links to extrinsic rights.
3. What are some key points to note?

- The SFC is now adopting a see-through approach in relation to tokenised securities and tokenised SFC-authorised investment products. This regulatory approach recognises that these products are fundamentally traditional securities with a technological element (i.e. the tokenisation wrapper).

- The overarching principle of the SFC’s regulatory approach is focused on “same business, same risks, same rules”. As such, the existing legal and regulatory requirements governing the traditional securities markets continue to apply to tokenised securities. Certain regulatory categorisation (e.g. the determination of whether these products are “complex products”) also depends on looking through to the underlying traditional security.

- Intermediaries engaging in tokenised securities-related activities should manage new risks arising from the use of DLT (i.e. ownership risks and technology risks) so that the tokenisation market can continue to develop in a healthy manner with proper regards to investor protection.

- The SFC’s previous Statement on Security Token Offerings from March 2019 (the “2019 SFC STO Statement”) is superseded by the Intermediaries Circular. In contrast with the SFC’s previous stance on security tokens, tokenised securities will not be deemed to be “complex products” and will not be restricted to offerings to professional investors-only.

- For tokenised SFC-authorised investment products, product providers involved in the primary dealing must ensure that they meet the additional requirements set out by the SFC to mitigate the new risks arising from the tokenisation arrangement. Secondary trading of tokenised SFC-authorised investment products would warrant more caution and careful consideration in order to provide a substantially similar level of investor protection to those investing in a non-tokenised product.

- Intermediaries will need to communicate with the SFC before engaging in activities in relation to tokenised securities or digital securities. Prior consultation with the SFC is required for product providers of new or existing investment products that will have tokenisation features and SFC approval may also be required for such changes.
However, intermediaries engaging in tokenised securities-related activities should manage new risks arising from the use of DLT so that the tokenisation market can continue to develop in a healthy manner with proper regards to investor protection.

2.1 Terminology

For the purpose of the Intermediaries Circular, the SFC defined “tokenised securities” as traditional financial instruments (e.g. bonds or funds) that are “securities” as defined in the SFO which utilise DLT (such as blockchain technology) or similar technology in their security lifecycle.

Tokenised securities are a subset of a broader set of “digital securities”. “Digital securities” is in turn defined as “securities” as defined in the SFO that utilise DLT or similar technology in their security lifecycle. For example, digital securities (which are not tokenised securities) may be structured in more bespoke, novel or complicated forms with no controls in place to mitigate risks (e.g. tokenisation of fractionalised interests in the real world, or digital assets such as artwork or land in a manner different from a traditional fund but such that the arrangement would amount to a collective investment scheme).

The Intermediaries Circular is primarily concerned with the SFC’s guidance to intermediaries on tokenised securities-related activities, i.e. traditional financial instruments which are securities with a technological element.

The SFC recognises that there is currently no universal definition or taxonomy for categorising tokenised securities and many different structures may exist in the market. There are slight variations across the SFC’s recent circulars and guidance relating to virtual assets and digitised instruments. For example:

> the SFC’s Guidelines for Virtual Asset Trading Platform Operators defines “Security Token” as “a cryptographically secured digital representation of value which constitutes “securities” as defined [under] the SFO”.

> the Intermediaries Circular defines “Tokenised Security” as “traditional financial instruments that are “securities” as defined [under] the SFO which utilise DLT (such as blockchain technology) or similar technology in their security lifecycle”.

The subtle differences between the definitions could make a difference between whether a product falls within the scope of a certain regime or not. As such, care should be taken when applying the SFC’s various regimes to a specific fact pattern.

2.2 Tokenised securities-related activities requirements

With the key requirement on intermediaries being to manage risk, intermediaries engaging in tokenised securities-related activities are required by the SFC to have the necessary manpower and expertise to understand the nature of such businesses and the new risks relating to ownership and technology. Intermediaries are also expected to perform due diligence on the tokenised securities and also on the technology aspects given the use of tokenisation technology.

**Issuance of tokenised securities by intermediaries**

Importantly, when intermediaries issue or are substantially involved in the issuance of tokenised securities which they intend to deal in or advise on (this would likely catch activities of arrangers to tokenised securities issuances in practice), they remain responsible for the overall operation of the tokenisation arrangement notwithstanding any outsourcing arrangements to third-party vendors or service providers. Intermediaries intending to engage in issuance type of activities with respect to tokenised securities should note the high level of accountability that the SFC is holding them to.
The SFC provided a list of non-exhaustive factors to guide intermediaries on how to assess risks related to the technical and other aspects of tokenised securities. The ownership risks and technology risks can be more pronounced for tokenised securities in bearer form which use permissionless tokens on public-permissionless networks and custodial arrangements should properly take into account these risks. The SFC also set out additional considerations for intermediaries to consider in ascertaining whether the custodial arrangements are appropriate and robust enough to effectively mitigate risks.

**Dealing in, advising on, or managing a portfolio investing in tokenised securities by intermediaries**

In other cases, where intermediaries deal in, advise on, or manage portfolios investing in tokenised securities, the SFC expects them to conduct due diligence on the issuers and their third-party vendors/service providers involved in the tokenisation arrangement, as well as the features and risks arising from the tokenisation arrangement. Intermediaries should understand and be satisfied with the controls implemented by the issuers and their third-party vendors/service providers to manage ownership and technology risks of the tokenised securities before they engage in related activities.

In practice, this will likely require an intermediary to conduct thorough assessments on the product issuer and the technology aspects of the tokenised securities and then arrive at their own conclusion that proper controls are in place to manage the ownership and technology risks. It is advisable for intermediaries to retain proper records to demonstrate to the SFC the procedures they have adopted to meet such requirements.

**Information for clients**

The SFC expects intermediaries to disclose to clients relevant material information specific to tokenised securities (including the risks of the tokenised securities) and to communicate such information in a clear and easily comprehensible manner. Intermediaries are expected to provide clients with material information on the tokenisation arrangement, for example: (i) whether off-chain or on-chain settlement is final; (ii) any limitations imposed on transfers of the tokenised securities; (iii) whether a smart contract audit has been conducted before deployment of any smart contract; (iv) key administrative controls and business continuity planning for DLT-related events; and (v) any applicable custodial arrangement.

Intermediaries which deal in, advise on or manage portfolios investing in tokenised securities as well as arrangers would be well advised to work with the product providers of the tokenised securities to obtain such information to the extent that it is not already included in the offering documentation prepared by the product provider. Intermediaries are also expected to communicate such information in a clear and easily comprehensible manner to clients so intermediaries should ensure that its relevant licensed/registered representatives are equipped with such knowledge.

**2.3 Digital securities-related activities requirements**

Where an intermediary engages in digital securities-related activities (i.e. digital securities which are not tokenised securities), the SFC requires it to implement adequate systems and controls to address the specific risks and unique nature of the digital security in order to protect the interests of its clients. Given the bespoke nature, terms and features as well as heightened legal uncertainties of certain digital securities which are not reasonably likely to be understood by a retail investor, digital securities which are not tokenised securities are likely to be regarded as “complex products” (triggering the relevant regulatory requirements associated with this product categorisation including the professional investor only-restriction).
3 The Product Circular – guidance to product providers of tokenised SFC-authorised investment products

The SFC similarly adopts a see-through approach in relation to tokenised SFC-authorised investment products. As such, on the basis that the underlying product meets all the applicable SFC product authorisation requirements for public offers, the SFC is of the view that it is appropriate to allow primary dealing (e.g. subscription and redemption) of tokenised forms of these underlying products. However, the key is for product providers to put in additional safeguards to address the new risks associated with the tokenisation arrangement.

3.1 Requirements on product providers

We summarise below the key additional requirements that product providers of tokenised SFC-authorised investment products have to comply with.

Additional requirements to address the new risks associated with tokenisation

Regardless of any outsourcing arrangement, the SFC holds product providers to be ultimately responsible for the management and operational soundness of the tokenisation arrangement adopted and record keeping of ownership.

Similar to the approach taken in the Intermediaries Circular, the SFC in the Product Circular identified ownership risks and technology risks as the two main types of risks in tokenisation activities. On the basis that tokenised SFC-authorised investment products can be offered to the public in Hong Kong, the SFC holds product providers to be ultimately responsible for these risks. Product providers should 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. The SFC advises against issuing tokenised SFC-authorised investment products in bearer form given the heightened cybersecurity risks involved.

In addition, product providers should have appropriate measures in place to manage and mitigate cybersecurity risks, data privacy, system outages and recovery, and maintain a comprehensive and robust business continuity plan. Product providers should also not use public-permissionless blockchain networks without additional and proper control (e.g. using permissioned tokens for additional control).

Upon request from the SFC, product providers should (i) 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; (ii) 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 (iii) obtain satisfactory legal opinion to support its application.

Product disclosure requirements

The SFC requires the offering documents of a tokenised SFC-authorised investment product to contain the following information:

1. the tokenisation arrangement, particularly, with clear disclosure on whether off-chain or on-chain settlement is final;
2. the ownership representation of the tokens (e.g., legal and beneficial title of the tokens, ownership of / interests in the product); and
3. 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.

Staff competence requirements

Product Providers are required to 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.

4 Next steps for intermediaries and product providers

Intermediaries interested in engaging in any activities involving any digital securities (including tokenised securities) should notify and discuss their business plans with the SFC (and, for registered institutions, the HKMA as well) in advance.

Product providers who wish to issue to the public new investment products with tokenisation features to the public should consult with the SFC prior to putting in its authorisation application. Prior consultation with the SFC is also requirement if product providers wish to tokenise existing SFC-authorised investment products and prior approval may be required for certain changes.

Linklaters has extensive experience in advising clients on digital issuances of debt and structured securities, including the inaugural issue of tokenised green bonds by the Government of the Hong Kong Special Administrative Region and the issuance of digitally native structured notes by BOCI. More recently, Linklaters advised Euroclear Bank on the development and launch of its Digital Financial Market Infrastructure (D-FMI) which enables the creation, issuance, and settlement of fully digital international securities. We would be delighted to share with you our experience. Please visit our Knowledge Portal where you can find our recorded client sessions and client bulletins written on the subject.