

RE: SFC CIRCULARS ON (1) TOKENISATION OF SFC-AUTHORISED INVESTMENT PRODUCTS; AND (2) INTERMEDIARIES ENGAGING IN TOKENISED SECURITIES-RELATED ACTIVITIES

On 2 November 2023, the Securities and Futures Commission (the “SFC”) published two circulars, namely: (i) circular on tokenisation of SFC-authorized investment products (the “**Tokenisation Circular**”); and (ii) circular on intermediaries’ tokenised securities-related activities (the “**Tokenised Securities Circular**”; together with the Tokenisation Circular, the “**Circulars**”). In this Client Alert, we summarise the regulatory approach set out by the SFC in the Circulars in relation to tokenised investment products and securities and share our views and observations on the subject.

A. Terminology and Concepts

To facilitate a better understanding of the Circulars, it will be helpful to define and distinguish the following terms and concepts at the outset:

- (a) “**Digital Securities**”: securities¹ which utilise distributed ledger technology (“**DLT**”) or similar technology in their security lifecycle;
- (b) “**Tokenised Securities**”: Digital Securities which are traditional financial instruments, such as tokenised bonds and tokenised funds;
- (c) “**Non-Conventional Digital Securities**”: Digital Securities other than Tokenised Securities, such as collective investment schemes² involving the tokenisation of fractionalised interests in real world assets (“**RWA**”);
- (d) “**Tokenised Authorised Products**”: tokenised investment products which are authorised or required to be authorised by the SFC for offer to the public under the Part IV of the SFO (the “**Public Offers Regime**”); and
- (e) “**Complex Product**”: an investment product whose terms, features and risks are not reasonably likely to be understood by a retail investor due to its complex structure.³

B. Regulation of Tokenised Securities

In the SFC’s view, Tokenised Securities are fundamentally traditional financial instruments with a “tokenisation wrapper” (i.e. a tokenised bond in effect remains a bond). As such, Tokenised Securities are subject to existing legal and regulatory requirements applicable to traditional securities⁴ and, at the same time, additional requirements intended to address the novel risks specific to tokenisation and DLT, especially the cybersecurity risks and ownership risks. These additional requirements include, without limitation:

- (a) **Integrity and soundness of the tokenisation arrangement**: Issuers and product providers of Tokenised Securities shall assume primary responsibility for the overall management and operation of the tokenisation arrangement, irrespective of any outsourcing to third-party service providers and/or vendors. Key considerations include: (i) the experience and track record of the third-party service providers and/or vendors involved; (ii) the technical aspects; (iii) the legal and regulatory status of the Tokenised Securities; (iv) business continuity planning; (v) data privacy risks; and (vi) money laundering

¹ As defined in Part 1 of Schedule 1 to the SFO.

² As defined in Part 1 of Schedule 1 to the SFO.

³ See Chapter 6 of the Guidelines on Online Distribution and Advisory Platforms and paragraph 5.5 of the Code of Conduct for Persons Licensed by or Registered with the SFC and the guidance issued by the SFC from time to time.

⁴ Including, without limitation, the SFC authorisation requirements under the Public Offers Regime, the prospectus regime (the “**Prospectus Regime**”) under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Chapter 32 of the Laws of Hong Kong) (“**CWUMPO**”), as well as codes, guidelines, circulars and statements published by the SFC which govern the conduct of intermediaries.

and terrorist financing risks;

- (b) **Due diligence:** Intermediaries which deal in, advise on or manage portfolios investing in Tokenised Securities are required to conduct due diligence on: (i) the issuer and the third-party service providers and/or vendors involved; (ii) the underlying product; and (iii) the features of, and risks arising from, the tokenisation arrangement; and
- (c) **Disclosure of information:** Issuers and intermediaries providing Tokenised Securities-related services are required to make adequate disclosure to investors of material information about the Tokenised Securities, in particular the tokenisation arrangement, ownership representation, custodial arrangement and the associated risks.

Reversal of automatic Complex Product classification

In contrast to the SFC's previous position that all security tokens should be regarded as Complex Products, thus requiring additional investor protection measures, the SFC now takes the view that whether or not a Tokenised Security is a Complex Product should be determined on a case-by-case basis using a "see-through approach" to assess the complexity of the underlying product.⁵

Removal of mandatory professional investor⁶ ("PI")-only restriction

With respect to the distribution and marketing of Tokenised Securities, the SFC has removed the mandatory PI-only restriction hitherto imposed upon intermediaries. However, it remains the case that, where an offer of Tokenised Securities has not been authorised by the SFC under the Public Offers Regime or has not complied with the Prospectus Regime, the offer can only be made to PIs or pursuant to other safe harbours provided by the CWUMPO and/or Part IV of the SFO.

Primary dealing only for Tokenised Authorised Products

With respect to Tokenised Authorised Products, the SFC has made it clear that, for the time being, it is only prepared to allow primary dealing of such products subject to compliance with the applicable product authorisation requirements and the additional safeguards as mentioned above. Secondary trading is not currently permitted due to concerns relating to ownership records, readiness of trading infrastructure, liquidity support and fair pricing, amongst other things.

C. Non-Conventional Digital Securities

The SFC noted that, in view of their bespoke nature as well as heightened legal uncertainties, Non-Conventional Digital Securities are likely to be regarded as Complex Products, so that intermediaries are required to ensure the suitability of such products for its clients in carrying out any sale or distribution, regardless of whether there has been any solicitation or recommendation.

D. Prior Consultation and Approval

Intermediaries that intend to carry out any activities relating to Digital Securities (including both Tokenised Securities and Non-Conventional Digital Securities) are required to notify and discuss with the SFC their proposed products and business plans in advance. Issuers of Tokenised Authorised Securities are also reminded that prior consultation with and approval by the SFC is still required even if the underlying product is an existing SFC-authorised investment product.

⁵ See footnote 3.

⁶ As defined in section 1 of Part 1 of Schedule 1 to the SFO.

Our Observations

The Circulars have provided much-needed guidance on the regulatory requirements and expectations for activities relating to tokenised securities and investment products amidst growing market interest in RWA tokenisation and similar projects. Nevertheless, given the nascent state of RWA tokenisation and STOs in Hong Kong, the approach set out in the Circulars remains a conservative one that leaves much room for further developments to provide a comprehensive framework to support the growth and diversification of DLT-based investment products in the longer term.

Whilst the SFC's greenlight (subject to approval on a case-by-case basis) for the offer of Tokenised Authorised Products is to be welcomed, the restriction to primary dealing and de facto prohibition of secondary trading would place significant limitations on the liquidity and market reach of such products. It would also appear to create the situation that existing listed SFC-authorised investment products, such as tokenised exchange-traded funds (ETFs) or tokenised real estate investment trusts (REITs), could not be traded on virtual asset trading platforms in Hong Kong (eg. OSL and HashKey) at the moment even if approved by the SFC for tokenisation. It is hoped that the SFC will ultimately adopt the "same business, same risks, same rules" principle to Tokenised Authorised Products, particularly given that requirements designed to ensure that novel risks associated with tokenisation are already being imposed by the SFC on Digital Securities.

Further, it appears from the Tokenised Securities Circular that the only forms of Tokenised Securities currently recognised by the SFC may be limited to tokenised bonds and tokenised funds. However, the mere tokenisation of conventional investment products may have limited appeal to investors, who might not see the advantage of investing in Tokenised Securities compared to their off-chain counterparts in the absence of any additional unique features, particularly in the case of Tokenised Authorised Products as their secondary trading is not currently permitted. Although the SFC has not explicitly prohibited the sale and offer of Non-Conventional Digital Securities, very little guidance has been provided by the SFC on the expected standards for their issuance, sale and distribution. In view of the SFC's stance that Non-Conventional Digital Securities are likely to be regarded as Complex Products and the requirement for prior consultation and approval by the SFC, it remains uncertain which Non-Conventional Digital Securities, if any, might be acceptable to the SFC to be offered to retail investors or even to PIs.

If you have any views or questions on the issues raised in this Client Alert or the Circulars or are interested in issuing Digital Securities, please do not hesitate to get in touch with our team members at ly@lylawoffice.com or at (+852) 2115-9525.

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