

THE  
INVESTMENT  
ASSOCIATION

C/M/S/  
Law.Tax

The Investment Association  
**Tokenised funds series**  
**Paper 2 - Regulatory**  
**considerations**

March 2021



**The Investment Association  
in partnership with CMS**



## About this paper

This is the second paper in the IA series on tokenised funds, in collaboration with CMS. In this paper, we explore the regulatory considerations associated with tokenised funds. The [first paper](#) in this series provides an introduction to tokenised funds and future papers will go into more depth on some of the technical aspects that the industry needs to consider to make them an effective proposition.

## 1. What is the regulatory status of UK tokenised funds?

There are no regulated tokenised funds in the UK at the moment but we expect that there will be in the medium term. The FCA has previously stated that the financial services regulatory regime is “technology neutral”. Therefore, similar to the traditional arrangements, a tokenised fund would also fall within the scope of the financial services regulatory perimeter and both the fund and all associated entities, such as the fund manager, will be subject to the UK regulatory regime.



**Recap**  
*A tokenised fund is a fund that issues digital tokens to its investors, rather than shares or units. The value of the tokens is derived in the same way, but a tokenised fund could offer quicker settlement timescales. The current centralised shareholder register is replaced by the distributed ledger, where the various participants each hold and maintain their own version.*

## 2. What might be the benefits of tokenised funds from a regulator’s perspective?

Regulators may be interested in the potential benefits of tokenised funds as they relate to efficiency and transparency of operation, particularly if there are demonstrable benefits for investors.

The role of DLT means that the tracking of movement of tokens becomes much easier and more reliable. DLT allows identical data sets to be shared across various parties on an immutable and real-time basis. The approach ensures the integrity of data across participants and reduces the need for duplicative record-keeping and reconciliation across entities. DLT could be a catalyst for simplified, more efficient workflows and potentially help to reduce costs that are ultimately passed onto investors.

Tokenised funds are also more transparent than their traditional counterparts in some aspect of their operations, due to their use of DLT. The rights of investors, legal responsibilities and limitations, along with an immutable record of ownership, can all be embedded directly onto the security tokens. This will make transactions in funds more transparent, allowing the parties involved to better understand the rights and obligations of one another.

Regulators have been responsive to creating a framework for tokenisation (see section 4 below for some recent developments in this space). The nature of tokenisation also means that funds would be programmable. This could benefit regulators as smart contracts could be used to automatically notify them when programmed regulatory restrictions are breached. This, in turn, would enhance regulators’ ability to improve clarity and protection for investors.

### 3. How are cryptoassets/tokens currently regulated in the UK and what does this mean for tokenised funds?

In the context of the UK regulatory perimeter, cryptoassets (colloquially referred to as "tokens") are currently split into three categories:

1. Security tokens: These meet the definition of specified investment as set out in the Regulated Activities Order and possibly also financial instruments as set out in MiFID II. These are the tokens that confer all or similar rights to those given to shareholders or debtholders;
2. E-money tokens: Cryptoassets that meet the definition of e-money; and
3. Unregulated tokens: Any cryptoasset that is not a security token or an e-money token, e.g. exchange tokens like Bitcoin and Litecoin or utility tokens which allow access to a service or network.

Activities that take place in relation to security tokens and e-money tokens are generally regulated by the FCA, meaning that FCA authorisation is required to carry out any investment services related to them in the UK. As shares or units in funds are specified investments, tokenised funds would be classed as security tokens.

The tokenised fund itself could invest in the same suite of underlying assets that it does today; ie it itself being a security token would not change the investible universe of stocks or bonds that it could hold. In the same way, traditional funds can already invest in security tokens and e-money as well as conventional assets, subject to its investment mandate and product type. A UCITS fund, for example, cannot currently invest in unregulated tokens such as exchange tokens, and a tokenised variant of the same fund would face exactly the same restriction.

It is important to note that tokens for these purposes are simply another way of recording ownership of a specified investment. Therefore, the regulatory rules and requirements relating to them will be the same as those which apply to the underlying fund. However, as stated in section 2 above, there are potentially various benefits to fund managers and other intermediaries through the use of DLT and tokenising a fund.

Policymakers are looking into the existing regulatory environment and changes are expected in due course in order to enhance the regime to cater for the increase in digital assets. In a recent Consultation Paper published by HM Treasury on cryptoassets and stablecoins<sup>1</sup>, the UK government called for public input to help develop its understanding of areas where further legal clarification is needed in respect of topics such as, among others, DLT. The responses to this Consultation Paper could shape the government's approach in reforming this area and the FCA's perspective on this new technology. The outcome of this could be the addition of new laws and regulations to govern DLT as well as cryptoassets and stablecoins more widely.



**Security Tokens & E-Money Tokens**  
*Tokenised funds are highly likely to fall within the scope of two cryptoasset regulatory categories:*

- Security Tokens - *in issuing tokens to reflect ownership in the fund*
- E-Money Tokens - *in issuing money tokens on the DLT in exchange for cash in order to facilitate settlement for the security tokens.*

For now, though, it is broadly expected that tokenised funds will sit within existing arrangements, and we will now explore some of these areas in detail.

#### Marketing and financial promotions

Generally, the marketing and financial promotions regimes governing tokenised funds is the same as traditional funds.

---

<sup>1</sup> HM Treasury: [UK regulatory approach to cryptoassets and stablecoins: Consultation and call for evidence](#) 2021

With regards to financial promotions, HM Treasury published a Consultation Paper last year which outlined its intention to bring certain cryptoassets into the scope of the current regime to enhance consumer protection<sup>2</sup>. As security tokens are already within the scope of the current financial promotions regime the Consultation Paper proposes to expand the scope of the rules to also include certain “unregulated tokens” (specifically those which are *fungible* and *transferable*). As mentioned above, funds shares or units would be deemed to be security tokens and, as such, would already fall within the same financial promotions rules as traditional regulated funds.

#### Legal ownership

In the context of funds, tokens act as digital representations of ownership, and aside from how the ownership of shares is represented there should be little difference between investing in a traditional and tokenised fund. However, the costs associated with maintaining investor registers, for example, including where there is secondary market trading, should be greatly reduced where ownership is represented using a token.

#### Regulatory documentation

The regulatory documentation requirements for tokenised funds are, at this stage, expected to be very similar to those that apply to traditional funds. There may need to be different terminology included and also revised descriptions of any operational changes where these are contained in fund prospectuses.

Additionally, due to it being a DLT-based fund environment, there is the ability to use “smart contracts”, which are self-executing, self-enforcing contracts governed by the explicit terms and conditions laid out within them, and potentially used, in the context of funds, for drafting fund documentation. This leads to a number of the benefits already discussed in this note. However, there still remains uncertainty surrounding the legal position of smart contracts in UK law. The Law Commission is requesting views to help inform its study on smart contracts<sup>3</sup>. It plans to publish an account of the current law and detail its application to smart contracts as it stands. From this, it then hopes to identify areas where reform might be necessary to encourage the use of smart contract technology more widely.



**Applying twentieth century rules to tokenised funds**  
*The laws and regulations governing our industry have been well established over many decades. Aside from the areas highlighted in this paper, small claritive changes may also be needed to the OEIC Regulations and FCA COLL handbook in areas such as the composition of the shareholder register, and how changes to historic records are managed on a decentralised register.*

#### **4. Where are things less clear and what are the major regulatory challenges faced by tokenised funds?**

The main regulatory challenges that tokenised funds face stem from the legal uncertainty around the status of tokenised assets within the established framework. In the UK, the UK Jurisdiction Taskforce recognises cryptoassets as property and smart contracts as enforceable under English and Welsh law<sup>4</sup>. However issues relating to the validity of smart contracts, how they are to be interpreted by courts, and the legal remedies for when they are vitiated (e.g. rendered defective due to mistake) still persist. It is also uncertain as to whether DLT records of cryptoassets are capable of amounting to a “register” for evidencing, consulting or transferring title to certain types of securities under private law.

The risks to operational resilience and business continuity may also be perceived to increase as a result of

---

<sup>2</sup> HMT: [Cryptoasset promotions](#) 2020

<sup>3</sup> Law Commission: [Call for Evidence on smart contracts](#) 2020

<sup>4</sup> UK Jurisdiction Taskforce: [Legal statement on cryptoassets and smart contracts](#) 2019

the greater reliance on technology. Operational resilience represents the ability of a firm to prevent, adapt, respond to, recover from and learn from operational disruptions. By reducing the number of intermediaries in the fund process and relying more heavily on DLT for a majority of its operations, tokenised funds will be considered to have a different risk profile than their traditional counterparts. These risks could be mitigated through the use of a credible network operator responsible for ensuring that the DLT network runs in accordance with sound policies and procedures.

There is also a perception that tokenisation is associated with higher risks of fraud and fraudulent transactions. This is often based on the limited traceability of cryptoasset transactions and shortcomings in compliance with AML and KYC procedures. However, tokenisation allows you to improve on the AML and KYC position of traditional funds. This is because it enables a fund to integrate compliance with AML and KYC into each token, adding more certainty to the process. As well as this, there are also specialised compliance solutions which are able to be used for these purposes.

Further issues that tokenisation faces stem from different national regulatory frameworks that are in place. For this to be alleviated, a global standard of regulating cryptoassets must be developed. Currently, within the EU, there are efforts being made to harmonise the regulation around cryptoassets to ensure a level playing field among member states<sup>5</sup>. The Financial Stability Board has also recommended a coordinated global approach to supervision and regulation of cryptoassets<sup>6</sup>.

These challenges can be addressed by financial regulators and policy-makers by giving clarity to existing laws and regulation on the treatment of tokenised assets.

## **5. What is the future regulatory outlook for tokenised funds in the UK?**

In recent years, the FCA and the Bank of England have committed to support the development of tokenised assets and DLT financial services more widely. For example, the FCA has established its Innovation Hub and Regulatory Sandbox which encourages the testing of DLT solutions. The FCA acknowledges the benefits of DLT, particularly in areas such as tracking financial crime and disruptive innovation that could benefit consumers.

The FCA is aware that novel products could arise in the future that may be difficult to categorise within the established framework of security tokens. It has therefore encouraged prospective token-issuers to consider from the outset whether their activities require regulation and has stated a willingness to legislate to redefine and expand the regulatory perimeter if necessary. This is particularly to avoid the issuing of cryptoassets that have comparable features to specified investments (such as shares or units in funds) but are structured in such a way that avoid the regulation.

Following the consultation period of the recent HMT Consultation Paper on cryptoassets and stablecoins, the UK government hopes to be able to use the information it gains to direct its future regulatory decisions.

In time, it is feasible that the views of the FCA may move away from tech-neutrality. There may be specific conduct rules that are implemented that are aimed at firms running within DLT-reliant environments. Similarly, increased disclosure requirements could be imposed on tokenised funds to reflect the perceived risks that surround them. These disclosures may be to outline potential limitations to the investors' protection as a result of participating in the tokenised fund. As well as this, with increased reliance on technology, regulators may focus in on the operational resilience of firms supporting tokenised funds.

Additionally, as mentioned above, the Law Commission is requesting views to help inform its study on smart contracts. It's call for evidence looks at a range of issues relating to smart contracts, including:

- The definition of smart contracts, how smart contracts are being or might be used, and the potential benefits and costs associated with the use of smart contracts;

---

<sup>5</sup> ESMA: [Initial Coin Offerings and Crypto-Assets](#) 2019

<sup>6</sup> FSB: [Crypto-assets: Work underway, regulatory approaches and potential gaps](#) 2019

- The formation of smart contracts, including the use of distributed ledger technology to conclude agreements, the intention of the parties to enter into legal relations, and the ability to satisfy statutory “in writing” and “signature” requirements;
- The interpretation of smart contracts within the legal environment;
- The remedies that might be awarded where a smart contract is vitiated, the code is incorrectly recorded, or the code does not perform as the parties expected;
- Consumer protection issues that might arise when non-code-literate parties enter into smart contracts, and how existing consumer protections might apply in the smart contracts context; and
- Jurisdiction issues.

It is only a matter of time before tokenised fund environments will take advantage of smart contracts when drafting fund documentation, and as such, the outcome of the Law Commissions’ request for evidence should be followed closely.

The regulators believe that a consistent international response to cryptoassets is essential. The UK is committed to being a thought leader in the global coordination efforts of different nations to ensure global coherence and mitigate risks to UK consumers (who may invest in tokenised funds outside the UK). The UK will advocate for issues relating to cryptoassets to be addressed through the G20 and G7. The EU is also considering wider proposals to regulate the cryptoasset industry (bringing in scope unregulated tokens)<sup>7</sup>, tackling digital risk by building operational resilience in the financial sector<sup>8</sup> as well as proposing a pilot to encourage DLT market infrastructure<sup>9</sup>. We look forward to seeing the output of the existing consultations and calls for evidence and the impact that this will have on tokenised funds and tokenisation more widely if they do.



**Tokenised funds series**

*This paper provides an overview of regulatory matters as they apply to tokenised funds as at March 2021 and future papers will delve into more technical detail in other areas. We are keen to hear from members on what is important to them – contact us with requests and suggestions at [john.allan@theia.org](mailto:john.allan@theia.org)*

---

<sup>7</sup> European Commission: [Markets in Crypto-assets](#) 2020

<sup>8</sup> European Commission: [Digital operational resilience for the financial sector](#) 2020

<sup>9</sup> European Commission: [Pilot regime for market infrastructures based on distributed ledger technology](#) 2020



**Sam Robinson**  
**Partner**  
**Financial Services Regulation**  
 T +44 20 7524 6836  
 E sam.robinson@cms-cmno.com



**Yasmin Johal**  
**Associate**  
**Financial Services Regulation**  
 T +44 20 7524 2623  
 E yasmin.johal@cms-cmno.com



**Christopher Luck**  
**Partner**  
**Indirect Funds and Real Assets**  
 T +44 20 7524 6294  
 E chris.luck@cms-cmno.com



**Aidan Campbell**  
**Partner**  
**Regulated Funds**  
 T +44 141 304 6112  
 E aidan.campbell@cms-cmno.com



**Charles Kerrigan**  
**Partner**  
**Banking & Finance**  
 T +44 20 7367 3437  
 E charles.kerrigan@cms-cmno.com



**John Finnemore**  
**Partner**  
**Corporate**  
 T +44 20 7524 6432  
 E john.finnemore@cms-cmno.com



**Kushal Gandhi**  
**Partner**  
**Litigation**  
 T +44 20 7367 2664  
 E kushal.gandhi@cms-cmno.com



**Phil Anderson**  
**Partner**  
**Tax**  
 T +44 20 7524 6048  
 E phil.anderson@cms-cmno.com



**Duncan Turner**  
**Partner**  
**TMIC**  
 T +44 131 200 7669  
 E duncan.turner@cms-cmno.com



**The Investment Association**  
 Camomile Court, 23 Camomile Street, London, EC3A 7LL  
[www.theia.org](http://www.theia.org)  
 Policy, Strategy & Research

© The Investment Association (2021). All rights reserved.  
 No reproduction without permission of The Investment Association

@InvAssoc @The Investment Association