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The Investment Association Publishes a "Blueprint" for Fund Tokenisation in the UK

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On 24 November 2023, the Investment Association published a report on behalf of the wider Technology Working Group to the UK Government's Asset Management Taskforce (the "**Working Group**") on a "Blueprint" for the implementation of a fund tokenisation regime in the UK (the "**Tokenisation Report**").

The Financial Conduct Authority ("**FCA**") which, along with HM Treasury is an observer to the Technology Working Group, also provided input on the Tokenisation Report and launched a new fund tokenisation page on its website.

The industry focus on fund tokenisation is mainly aimed at authorised funds in the UK, rather than the unauthorised funds that are typically used within the traditional institutional-investor-focussed private equity space, but the information contained herein will nonetheless be of interest to the wider market and it will be interesting to see how things develop for the industry as a whole.

What is the purpose of the Tokenisation Report?

The Tokenisation Report details the Working Group's first phase of work on harnessing the potential of technological innovation for the UK asset management industry by way of applying distributed ledger technology ("**DLT**") through investment fund tokenisation. The overall objective behind the tokenisation of fund interests and the associated technology is to *"improve efficiency, transparency, and the international competitiveness of the UK's investment sector."*

The Tokenisation Report set out the following, in three distinct sections:

1. the context, rationale and background as to why tokenisation is important to the UK investment management industry, as well as detailing some work that has been done to-date in the UK and elsewhere;
2. the long-term aim for an investment fund value chain based on DLT; and

3. the “Blueprint” for implementation of a fund tokenisation regime, detailing the key items that the industry, regulators and government can progress towards that vision.

A “staged approach” to fund tokenisation…

The Working Group has set out a staged approach to implementing fund tokenisation in the UK, starting with a “baseline model” before considering more complex approaches. The Tokenisation Report refers to this “stage one” tokenised investment fund as having the following characteristics:

1. the fund would be an authorised fund in the UK and in scope of the existing legal and regulatory regimes;
2. the fund would hold mainstream investment assets held by a custodian, such as equities and bonds, consistent with existing authorised funds in the UK (and would not hold cryptocurrencies);
3. fund settlement would be entirely “off-chain”, with no use of any form of digital money and on the same timescales as a typical authorised UK fund. Payments records would need to interact effectively with the unit register and comply with existing client money requirements for designated investment business;
4. access to the network will need to be permissioned and tightly controlled to ensure that all participants are identifiable and have a legitimate interest, with data sharing control as appropriate;
5. fund valuation would need to be provided daily or on another timescale consistent with regulatory and market practice;
6. the traditional fund register would be replaced by DLT records and firms would need to be able to demonstrate their ability to exercise control over the register by having the ability to execute one-sided transactions outside of the consensus mechanism or to prevent transactions where required; and
7. the developments under this stage should not restrict future innovation or interoperability.

The Working Group states that, having agreed the nature of stage one, characteristics of future stages of work will be considered in more detail in the Working Group’s second phase of work towards the end of 2023.

What recommendations are set out by the Working Group as a “Blueprint” for fund tokenisation?

The Working Group highlights nine items as a “Blueprint” for fund tokenisation in the UK, which are a combination of (i) three items (1 to 3, below) that are to be navigated in order for firms to utilise the “stage one” model (as outlined above) effectively, and (ii) a further six items (4 to 9, below) that are relevant to certain use cases which may be a feature of future stages (or whose remedy would provide a useful enabler for the shared vision). These nine items are as follows:

1. **Regulatory certainty for UK fund tokenisation:** The models of fund tokenisation that follow the “stage one” characteristics should be capable of complying with the existing regulatory framework. As individual models of fund tokenisation may differ, the FCA expects firms to undertake their own due diligence to ensure that they comply with their legal and regulatory obligations.
2. **Foster DLT innovation across UK investment management industry:** The industry should leverage collaborative engagement with the relevant authorities and reinvigorate its innovation agenda to deliver change. Accordingly, the Investment Association will act as a conduit between the industry, FCA and HM Treasury to progress future stages of fund tokenisation and help firms engage with relevant officials.
3. **Money Laundering Regulations Registration Process:** Currently, firms proposing to use DLT for fund tokenisation may be required to register with the FCA as a “cryptoasset exchange provider” and/or a “custodian wallet provider” under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (the “**MLR**”) and the time it can take to obtain registration can act as a potential barrier to using fund tokenisation. The FCA is exploring whether it could determine MLR applications more quickly for firms which are already authorised and where there is a lower risk of harm.
4. **Industry to develop the details of further stages of fund tokenisation:** As the Tokenisation Report sets out the first stage of tokenised investment funds, the industry should work to develop details of further stages and, once they have been detailed, it should work with the FCA and HMT to consider updates to the FCA Handbook of Rules and Guidance and applicable legislation.
5. **Availability of digital forms of money to settle transactions:** The industry should work to decide upon the optimal form of digital money for fund transaction settlement, working with the relevant authorities.
6. **Legal considerations for investible assets:** Given that the ability of investment funds to hold tokenised versions of mainstream assets may be assisted by legal clarification, the Working Group recommends that industry participants work with HM Treasury to identify barriers in this regard and work

towards enabling any necessary legislative change (potentially via HM Treasury's Digital Securities Sandbox).

7. **Central Securities Depositary requirements and evolution of responsibilities:** Holding a digital security via a traditional securities depositary may not be an optimal process and this could be something that is addressed via HM Treasury's Digital Securities Sandbox.
8. **Availability of digital identity:** The Working Group recommends that the government supports building awareness of (and industry adoption of) the digital identity legal framework set out in the Data Protection and Digital Information Bill.
9. **Availability of Banking Services:** HMTreasury should consider whether further action is needed on access to business accounts.

Conclusion and what next?

The Tokenisation Report notes that the "stage one" workstream, including the above "Blueprint", establishes the infrastructure for fund tokenisation in the UK funds market and puts a foundation in place.

The Working Group will look at further stages of fund tokenisation as part of a "stage two" workstream and will monitor progress against the short-term recommendations set out in the Tokenisation Report.

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