

Will blockchain finally disrupt the full funds value chain in 2023?

Unlocking opportunities in funds tokenisation, investment in crypto assets and secondary markets

A CMS report

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Forewords

Blockchain, tokenisation and crypto assets are fast becoming established features in the funds landscape.

The opportunity is enormous. Recent estimates put the crypto currency market at around \$1trn globally.

The elder statesman-like funds and asset management industry towers above, at around 100 times the size. If just a fraction of these massed assets are directed towards crypto securities or become digital assets themselves, then we will see mushroom-like growth.

This is not all. The funds industry is starting to welcome new investors with a digital outlook – thanks partly to demographic change, particularly in Asia. Fund groups are already working out how to transition their operational infrastructure to blockchain technology. New investment opportunities, such as securitised crypto assets, are also now coming on stream.

The pace of change is so quick, it is reasonable to expect some form of disruption or at least transition in the funds industry next year. Whilst there may be current issues in the news for crypto currencies there is a clear direction for the use of digital technology alongside appropriate regulatory and technical infrastructure.

Many fund industry experts certainly think so – judging by their poll responses at our recent hybrid seminar, an event on which this compact report is based.

Overall, this report aims to show where blockchain, tokenisation and crypto assets stand in the funds landscape – and where they might settle in a year or so.

It features the views of CMS specialists and leaders in the fields of tokenisation, settlement, depository services and portfolio management.

Their insights offer much food for thought – not least the fact that this opportunity is not jurisdiction specific. If anything, jurisdictions may act to impede rapid change, to the extent that appropriate regulation and legal advice is not only necessary but essential to make the opportunity workable.

Overall, this is a remarkable opportunity for the industry – and we hope you find our summary useful.



Chris Luck
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Funds tokenisation



Technical briefing:

*José Juan Ocaña
Senior Associate
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Technology is moving faster than the law. It is why some issuers have experienced setbacks from a legal perspective when it came

to issuing or investing in tokens.

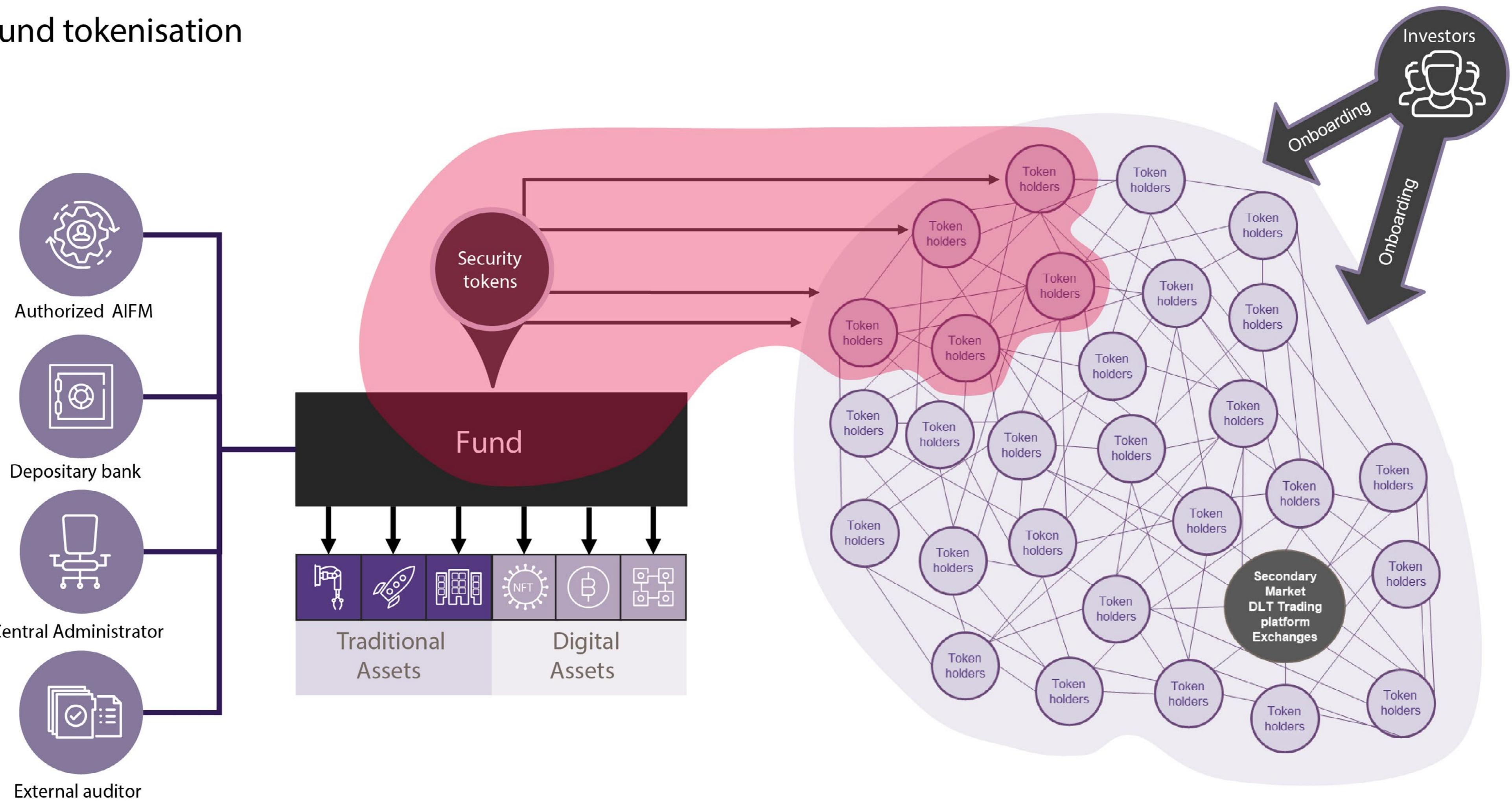
That said, progress from a legal perspective is uncovering two themes in fund tokenisation:

- An intermediate solution, combining digitisation of a fund to integrate blockchain while maintaining traditional
- The second, and more innovative way, is the native token system. This sets aside traditional registration and

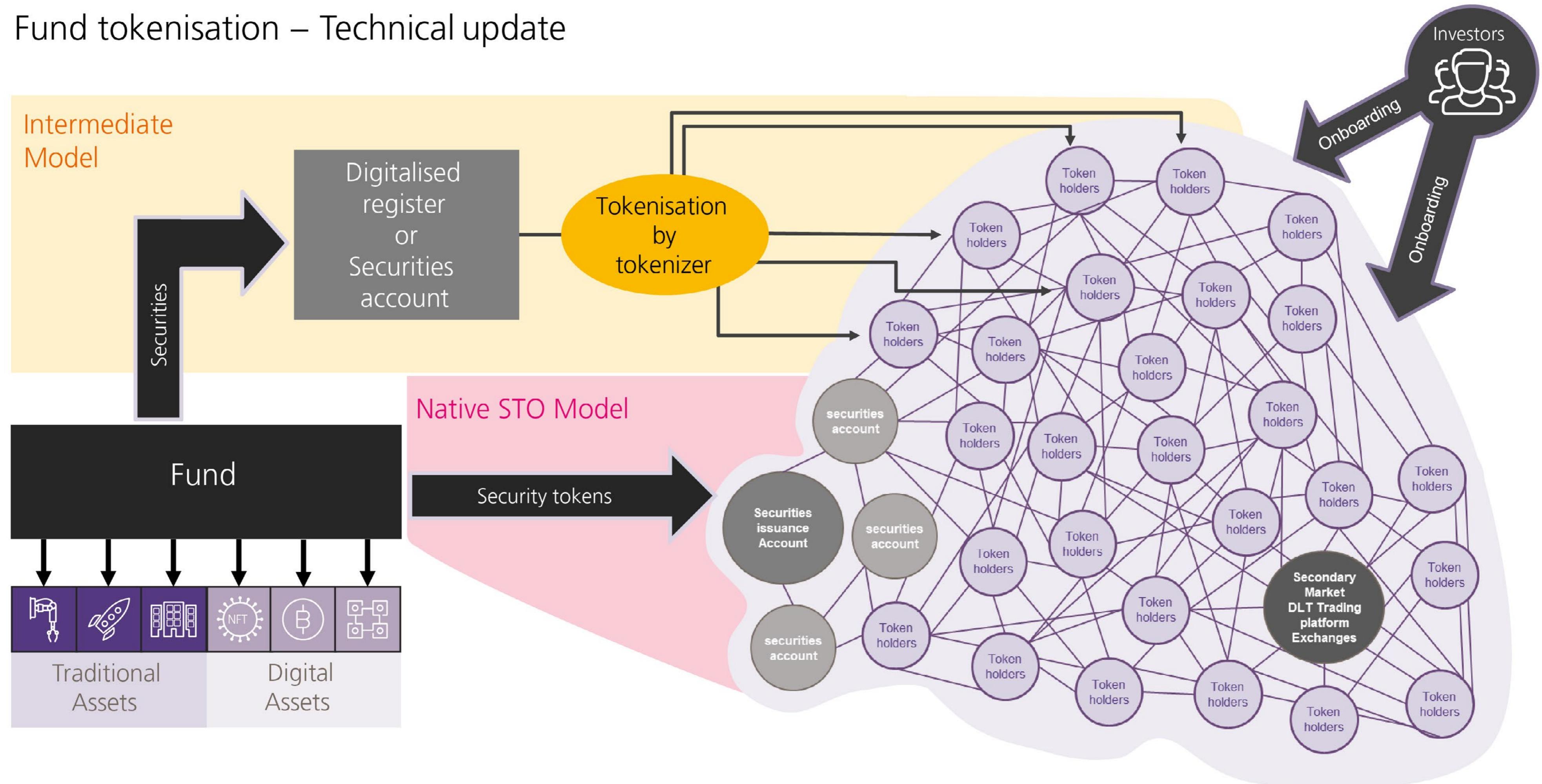
registration in compliance with the law. This enables issuers to benefit from the advantages of blockchain while the legal system gets ready for full integration.

transferability methods. It also opens the door to distributed ledger technology (DLT) as the main decentralised centre, whether funds can issue tokens directly and where rules governing funds' payment rights.

Fund tokenisation



Fund tokenisation – Technical update



Our expert panellists



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Luc Falempin
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Maroun Altekly
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A recent report from BNY Mellon indicated that 97% of institutional investors believe that tokenisation will revolutionise asset management. And that this tokenisation will bring positive benefits to the industry.

Tokeny's Luc Falempin certainly concurs with these findings: "Once, we used to have to convince large institutions to use blockchain. We've had that conversation. Now, institutions

just want to know where to start.

"We see a massive adoption coming. We are probably one of the leading tokenisation platforms – just our clients alone plan to bring \$1trn into blockchain in the next two years. This means leading groups such as JP Morgan, Apex, Fidelity and other players are convinced that blockchain is the way they need to go."

Firms adopting tokenisation are likely to see numerous benefits. The one perhaps most talked of is increased accessibility. For example, a fund group can reach new types of investors in new geographies far more easily.

¹ Insert source here (I couldn't find it)

Seminar poll: Will tokenised funds take off in 2023?

- Likely – 31%
- Perhaps – 33%
- Unlikely – 36%



But perhaps of greater impact is increased speed. Once everything becomes tokenised, there is little need for a custodian for settlement because it happens instantaneously. Everything becomes instant.

Falempin adds, *“Aside from speed, the other thing of course is that increased automation means you can execute operations on the blockchain just by contract. Corporate actions are simpler. Compliance is easier. Costs are lower.”*

If the industry is serious about attracting new investor demographics, then blockchain can sit in the middle of its solutions. In fact, the fund tokenisation community is already seeing it happen, as Opportunity’s Hugo Vautier explains.

“We are no longer dealing with a couple of large institutional investors. They have been joined by a far higher volume of private investors – hundreds to thousands – especially in the alternative investment strategies that are now proving so popular. This volume demands

new rules and processes to deliver the required client experience, cost-efficiency and speed of operations. Blockchain is essential.”

Clearly such technological advances are a big step for some. Retail investors – often with lower levels of expertise and understanding compared to their institutional counterparts – need to be led gently down the tokenisation path.

Maroun Altekly at BlocHome/LetzToken argues that a cautious approach is required:

“There’s some resistance to blockchain from retail investors – based on misconceptions about what blockchain is. The way forward is to focus on the benefits that blockchain can bring – and stop talking about what blockchain does. Then we’ll see wider acceptance and adoption.”

“The approach worked for us and now we’ve welcomed more than 1,200 people on platforms. This is just in Luxembourg. The goal is to harness this community spirit.”

Funds investing in crypto assets



Technical briefing:

Sarah Hantscher,
Managing Associate,
CMS Luxembourg

There is currently no specific regulation at EU level with respect to fund investments in crypto assets. What we do observe, however, is a reluctance to allow certain investment funds opened to retail investors to invest in crypto assets (coins, tokens,

NFTs, depending on the context). This is the case notably in Luxembourg, where the regulator has reminded that UCITS, UCIS addressing non-professional investors and pension funds, are not allowed to invest directly or indirectly in crypto assets.

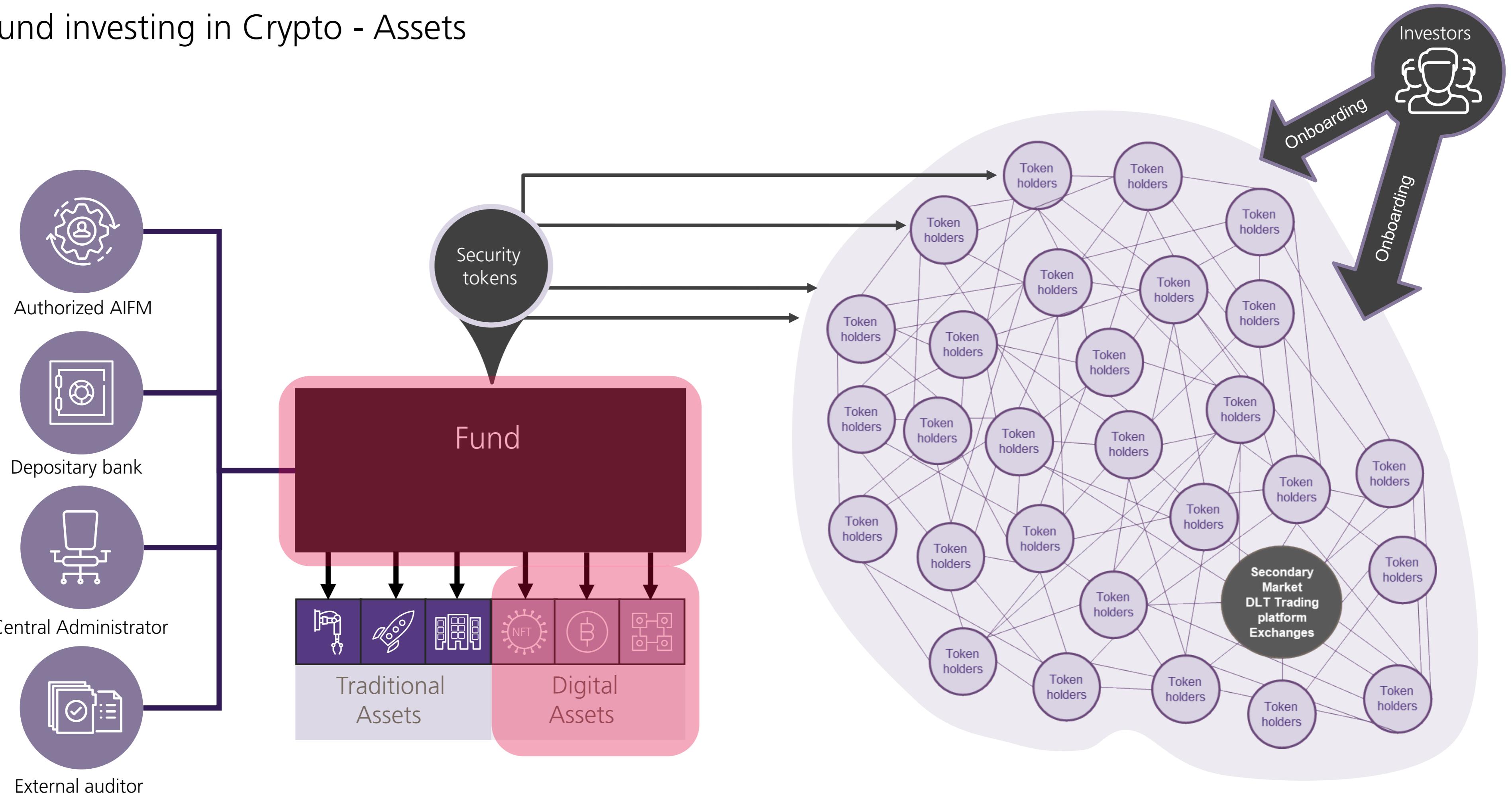
Moreover, Luxembourg registered funds are subject to stringent regulatory requirements when investing in crypto assets.

Fund managers in particular will in this respect need to apply for an extension of authorisation for their new investment strategy involving crypto assets, adapt the investment policy of the fund and the fund's risk profile, inform the investors, etc.

Finally, one last crucial topic is the one of custodians. In this respect, the holding of non-crypto (traditional) assets and crypto-

assets needs to be distinguished. For crypto-assets, the question will be as to whether the custodian of non-crypto assets is also authorised to hold crypto assets and if not, the investment fund will need to rely on a third party to that effect – typically, wallet service providers, authorised for example as VASPs in Luxembourg, as PSAN in France or, soon, as custodians under MiCAR.”

Fund investing in Crypto - Assets



Our expert panellists



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Paolo Bonolis:

When considering crypto, blockchain and tokenisation for the fund industry, one of the biggest questions is, 'what's the demand?'

Today, and looking out into 2023, the clear signs are that demand is healthy and growing, as Kais Haj-Taieb from Caceis contends: "We see a lot of interest from institutional investors in this new asset class. That interest falls into one of

two camps. The first is specific funds investing in cryptos directly and also mainstream funds allocating a portion of their assets to cryptos.

"The second is funds trying to invest in other kinds of assets that are financial instruments. In both cases we need to see adaptive changes to the value chain for all custody and trade management services. And, of course, that's where we come in because, for a lot of fund

managers, this isn't their core business."

Other leading experts echo such thoughts. Take Wojciech Kozlowski, at Q Securities. The company is Luxembourg's first investment firm authorised by the financial regulator to act as a depositary for alternative funds.

Not every fund group is courageous enough to enter crypto space. But, as Kozlowski

explains, *"This is why we have developed new, crypto depositary services. In fact, we have funds that are waiting to be serviced – they are simply missing the fund manager. By early next year we expect to see the first fund manager achieve approval in this space."*

The view from fund managers, sitting on the other side of this table, is remarkably similar. Funds want tokenisation and are seeking partners.

Seminar poll: Which will most affect funds investing more in digital assets in 2023?

- Investor demand – 62%
- Digital infrastructure – 38%

Ryo Ota from NordicNinja, a Japanese deeptech fund based in Europe, confirms that, *"As a fund we're moving to an authorised AFM status very soon. We've been looking at how to do this. Ultimately, we're seeking an authorised virtual asset service provider (VASP) to hold the tokens for us and also an authorised depositary. It's a tremendous opportunity."*

In real estate investing, with tangible and real assets, the view is broadly the same. In fact, digital asset specialist Mattereum has already devised a way of trading a real estate asset via a non-fungible token (NFT).

Jeremy Barnett, Resilience Partners, takes up the story:

"This is already happening. The only question is when the liquidity will be there to facilitate a functioning market. Now, activity is focused on smaller, residential buildings but when we see appropriate levels of liquidity this market will blossom."

"One of the things that will support demand is new investors. There's a lot of talk about traditional investors becoming converted to crypto assets. But we take a different view. We believe new investors are more likely to be those already holding crypto assets, most probably from the Far

East. So, the industry should really be making tokenised assets available to crypto investors so they can de-risk their portfolios."

As this demand grows, greater focus is inevitably being placed on the regulatory environment. Is regulation keeping pace with innovation?

Kozlowski thinks it is coming, despite a current absence of regulatory clarity and despite recent setbacks for the industry, notably the FTX collapse. He suggests, *"institutional investors want to have clarity that their assets are kept securely with all the correct technology, certifications, and so on. This is a good opportunity for*

Luxembourg – and it is important not to miss the train. The regulatory aspects covered by MiCA (Markets in Crypto-assets) will improve the framework for investors and the broader investment industry.”

Ryo takes a pragmatic view, “*I see this as a change in direction – every downturn leads to a change in course. There will be a call for more decentralisation. Once decentralised activities take off, they will lead to higher valuations and it’s wise for venture capital firms to take part in investing in digital assets.”*

But if the friction caused by incomplete regulatory framework is easing – there are other brakes on fast growth, at least for now.

Haj-Taieb explains, “*We are still missing some links in the value chain for the service to be fully developed. MiCA is one. National frameworks are others. We need cash on the same chain. Looking at digital assets globally, we are missing standardised smart contracts. One day we will have all the actors working together to develop the system. Things are not moving as fast as any of us would like but at least we are heading in the right direction. This is just the beginning.”*

Secondary transactions and distribution aspects: Q&A with Montis Group



Technical briefing:
Mélanie Poirier
Managing Associate
CMS Luxembourg

The question of transferability of tokens amongst investors generates significant legal implications. For example, how can tokens be distributed or traded amongst investors in

the crypto space?

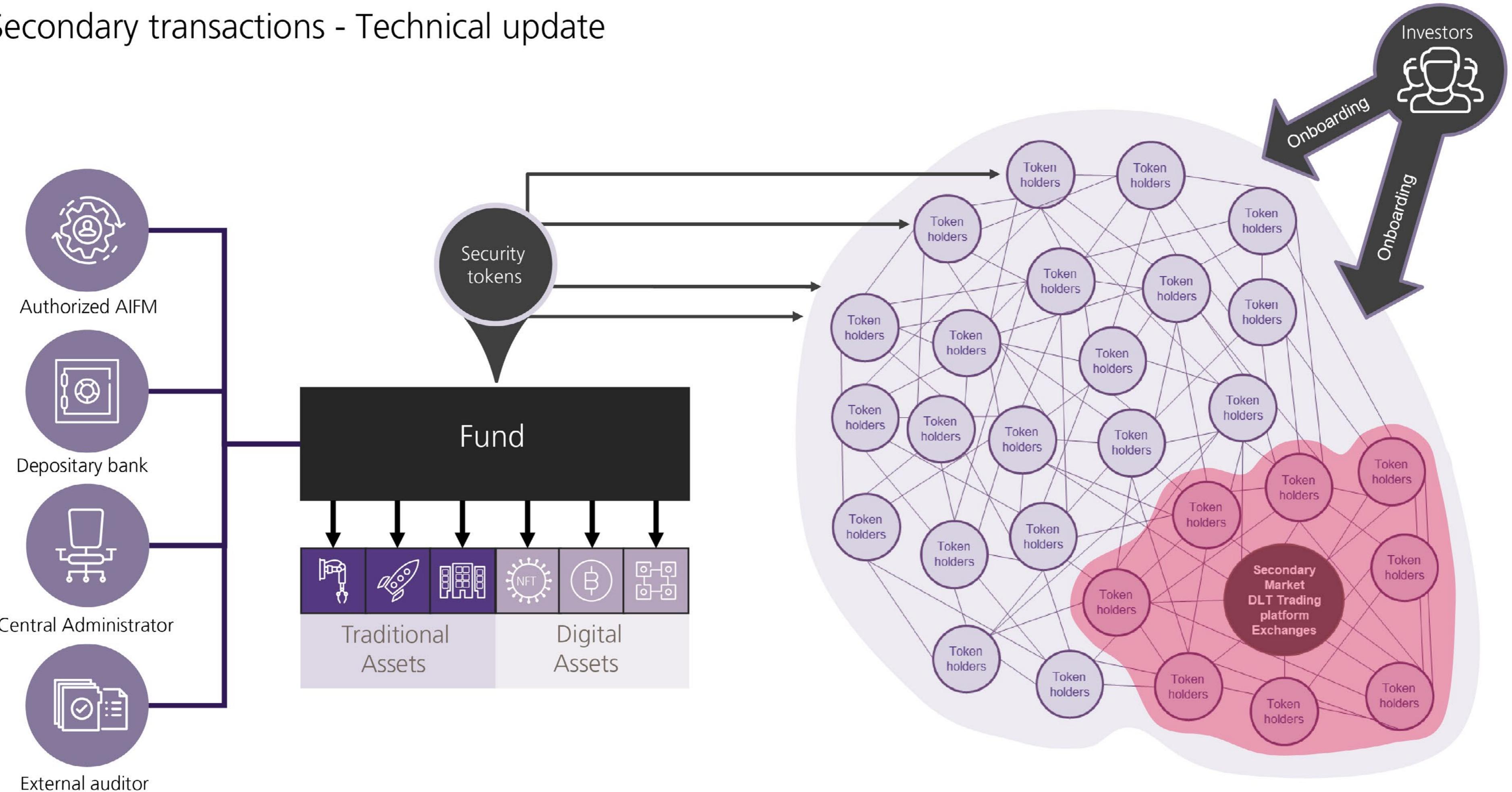
The development of tokenisation in the financial market comes together with the need for market infrastructures. The regime applicable to market infrastructures depends on the legal qualifications of the tokens as either financial instruments under MiFID or crypto assets

within the meaning of MiCAR. For tokens qualifying as financial instruments, the entry into force of the DLT pilot regime, set for March 2023, will permit the use of blockchain technology in trading and post trading processes by opening the possibility of a DLT marketplace infrastructure under certain conditions. The DLT pilot regime

will therefore allow trading and settlement of tokens qualifying as financial instruments. This will open the door to, for instance, CSDs to operate on the DLT.

For tokens qualifying as crypto assets, MiCAR will set out the conditions to be authorised as a crypto service provider operating a DLT crypto trading platform.

Secondary transactions - Technical update



Our expert panellists



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Martin Watkins
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Viémont: Can you explain your role – and that of Montis – in this changing landscape?

Watkins: Montis Group is a digital asset solution. We're owned by Archax, which is the first and only FCA permissioned NFT custody service for digital securities. Our clients have conventional and crypto securities – and Montis has the rights to tokenise these.

Everyone asks where the demand is. Well, we're talking with 91 asset managers. On balance, they're looking to digitise or tokenise funds, money markets and real estate.

Viémont: How will you deal with different types of asset classes?

Krishnan: We look at regulated securities under MiFID – bonds, fixed income, equities, structured products, and so on. We look at them in terms of natively issued securities, issued onto blockchain and tokenised.

Market demand at the moment is around 40% for tokenised, 60% for native digital issuance. Much of this is the tokenisation of money market funds and open- and closed-ended real estate funds. There is also interest in ETPs, where you would put a security wrapper

around crypto assets.

More broadly, banks and fund managers we talk to have demands across blockchain networks – some want wallets on specific settlement ecosystems, others want to bolster their offering for cash settlement on blockchain. Interest is strong.

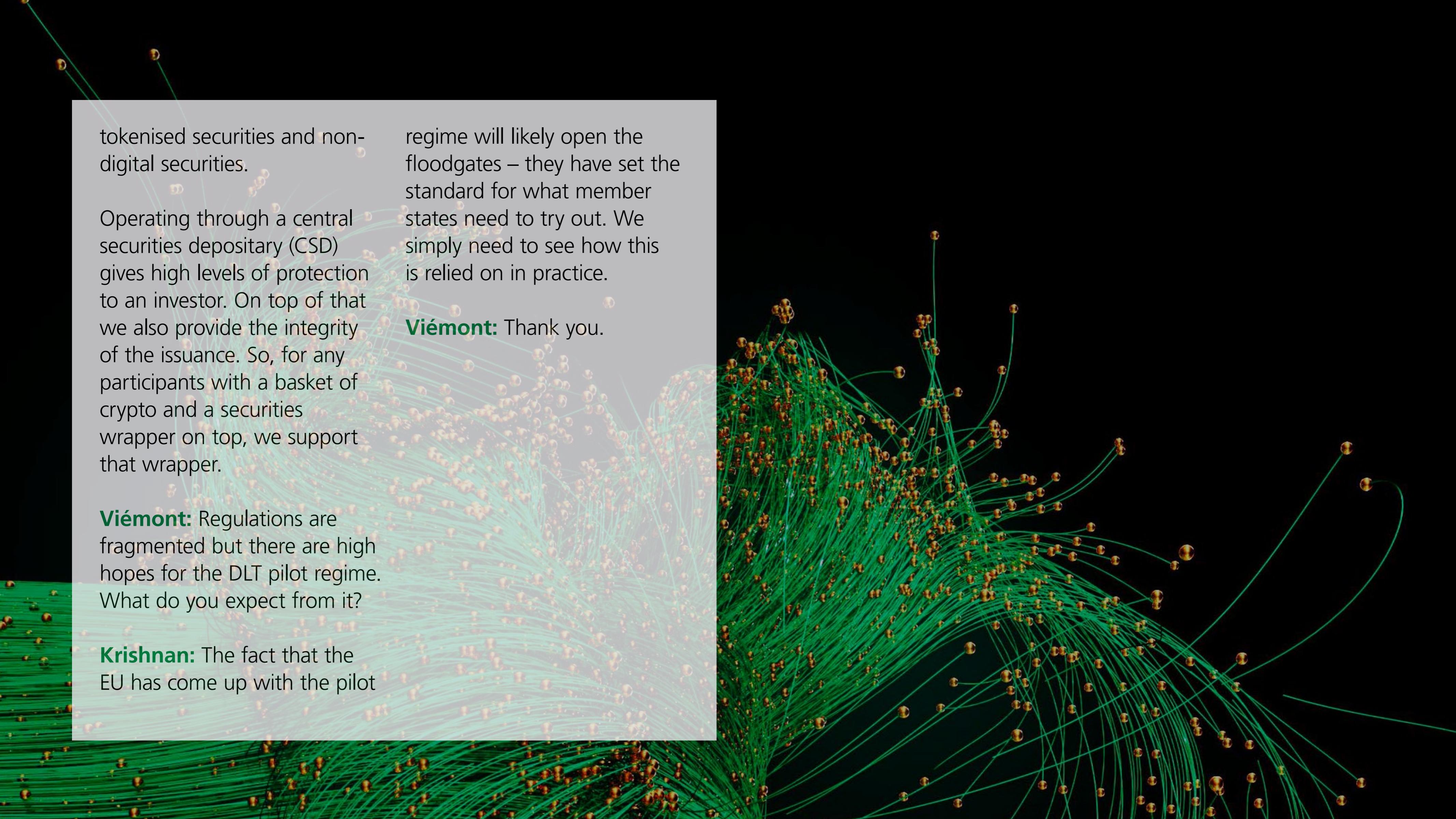
Seminar poll: Is the trading of tokenised funds on the secondary market likely to occur in 2023?

- Likely – 29%
- Perhaps – 33%
- Unlikely – 38%

Viémont: What post trade services will the market be able to offer?

Watkins: Having worked with legal counsel at CMS, we identified the jurisdictions and laws to support settlement of natively digital securities and non-native tokenised securities. This is crucial because we need to identify the regimes that allow us to provide notary services to record and change records on blockchain.

Montis is currently applying for a CSD authorisation in Luxembourg in order to enable the settlement of the natively digital securities, non-native



tokenised securities and non-digital securities.

Operating through a central securities depository (CSD) gives high levels of protection to an investor. On top of that we also provide the integrity of the issuance. So, for any participants with a basket of crypto and a securities wrapper on top, we support that wrapper.

Viémont: Regulations are fragmented but there are high hopes for the DLT pilot regime. What do you expect from it?

Krishnan: The fact that the EU has come up with the pilot

regime will likely open the floodgates – they have set the standard for what member states need to try out. We simply need to see how this is relied on in practice.

Viémont: Thank you.

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