

Tokenised funds series Paper 3 – Prospectus disclosures

About this paper

This is the third paper in the IA series on tokenised funds, in collaboration with CMS. Previous papers have provided an overview of the concept and the regulatory environment. In this paper, we explore the considerations firms should make regarding prospectus disclosures for regulated collective investment schemes. This is an evolving topic and the regulatory position and the requirements for the launch of such funds is still early.

What are tokenised funds?

As discussed in earlier papers, the Financial Conduct Authority (“FCA”) takes a technology-neutral view on regulation. A tokenised regulated collective investment scheme may take the form of:

- a unit trust (AUT);
- an open ended investment company (OEIC); or
- an authorised contractual scheme (ACS),

It has units, shares or interests (as appropriate) which are represented digitally in the form of tokens and can be traded and recorded using distributed ledger technology (“DLT”).

Funds in corporate form include:

- investment trusts;
- non-UK investment companies; and
- Real Estate Investment Trusts (REITs).

Investment will usually be an investment in shares or possibly debentures issued by the relevant company.

The share itself will not be a digitalised security for UK company law reasons but will typically be registered in the name of a nominee and a security token issued to represent the right to it.

In the context of the UK regulatory perimeter, the fund will be issuing regulated tokens in the form of security tokens: These are the tokens that confer all the rights given to shareholders or unitholders.

Prospectus requirements – regulated funds

The FCA’s Collective Investment Schemes sourcebook (COLL) requires the publication of a prospectus in relation to a regulated collective investment scheme in order that investors and potential investors can access detailed information about the fund. COLL also prescribes certain content for such a prospectus^{1,2}.

Given the FCA’s technology-neutral approach the regulator would be expected to require a tokenised fund to produce a prospectus for the purposes of COLL although it is too early to say with certainty what differences there may be in the required disclosures contained within the prospectus for a tokenised fund.

From applying the current COLL requirements to a tokenised fund the differences in disclosures are likely to be around the following:

- a description of the mechanics behind the tokenisation, such as:
 - the particular DLT solution adopted by the authorised fund manager and the tokens themselves;
 - any restrictions on entry to the network or specific tech/IT requirements of investors;
- details of entities involved in the tokenised fund, together with summaries of the relevant contractual arrangements, that would not be found in a prospectus currently, such as:
 - the DLT network provider;
 - the cash exchange provider;

¹ See COLL 4.2.5R and 8.3.4R

² Other sources of prospectus requirements such as the FCA’s Fund sourcebook in respect of alternative investment funds are not considered in this paper.

- details of any differences to AML/KYC requirements on investors, such as:
 - the method for AML verification;
 - whether any syndication of AML across network participants will be utilised;
 - any differences in documentary checks;
- details of the arrangements for dealing within the tokenised fund structure, such as:
 - any alterations to dealing cut-off times or mechanics;
 - any alterations to settlement timings or mechanics;
- details of specific risks arising from the shares/units in the fund being tokenised, such as:
 - reliance on the relevant DLT;
 - relative novelty of the concept in UK practice;
 - a summary of any legal uncertainty; and
- any other differences in respect of the operation of the fund due to it being tokenised.

Current status

At the time of writing, the IA is aware of a number of initiatives using or seeking to enable tokenised funds within the UK, in Luxembourg, Ireland and France. It seems likely that the first UK-domiciled tokenised fund, or at least class of a fund, will be available in the near future. Future adoption of the model will depend on the ability to realise the claimed benefits.

Corporate funds

If a token is a transferable security for shares or debt and the tokens will either be offered to the public in the UK or admitted to trading on a regulated market, an issuer will need to publish a prospectus unless an exemption applies, such as an admission to trading exemption.

A public offer of securities will need to have the prospectus reviewed and approved by the FCA, where the UK is the relevant home state regulator. If the securities are to be listed on the Official List maintained by the FCA (listed securities) and admitted to trading on a recognised investment exchange (like the London Stock Exchange's Main Market) similar requirements apply. The UK still awaits a listed fund or company which has listed security tokens but the FCA and the London Stock Exchange are understood to be looking at this.

A corporate fund prospectus must provide prospective investors with information to make an informed investment decision. The specific disclosure requirements will depend on the type of security (e.g. shares, bonds etc) as for the existing securities. It will include information amongst other things about:

- the security tokens and underlying securities;
- the Issuers of the tokens /the issuer of the related securities;
- the business or relevant assets,
- management and investment strategy;
- the historic financial information requirements;
- a working capital statement for its present requirements (at least 12 months from the date of the prospectus);
- a capitalisation and indebtedness statement dated within 90 days of the document;
- risk warnings (these will need to be expanded for any risks for the security tokens such as custody and use of DLT); and
- a responsibility statement by the directors or company depending on the nature of the issue.

If the securities are to be listed on the Official List maintained by the FCA (listed securities) and admitted to trading on a recognised investment exchange (like the London Stock Exchange's Main Market) similar requirements apply. The UK still awaits a listed fund or company which has listed security tokens but the FCA and the London Stock Exchange are understood to be looking at this.

Listed issuers of tokens or those admitted to trading on a recognised stock exchange will also have similar requirements as well as continuing obligations such as under the Disclosure Guidance and Transparency Rules and Market Abuse Regulation

Do the marketing and financial promotion rules apply?

Generally, the marketing and financial promotions regimes governing tokenised funds is similar to traditional funds. As security tokens are considered specified investments under the RAO, these already fall within the scope of the current financial promotions regime.

The financial promotions requirements and exemptions will also be relevant to security tokens which are marketed on a restricted basis without the need for a prospectus.

What are the challenges?

The main regulatory challenges that tokenised funds face stem from the uncertainty around:

- the status of tokenised assets within the established framework;
- the regulator's appetite for tokenised funds;
- adoption and launch of funds;
- familiarity with the product and by advisers;
- 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;
- operational resilience and business continuity along as a result of the greater reliance on technology;
- perception of high 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 (these may be enhanced by DLT); and
- varied national regulatory frameworks in operation.

What is the current outlook for tokenised funds?

This is a quickly evolving area. The recent Consultation Paper published by HM Treasury on cryptoassets and stablecoins³, will hopefully shape the FCA's perspective on this new technology. The outcome of this could be the addition of new laws and regulations to govern DLT and cryptoassets. There is increasing interest and activity to create the product.

Tokenised funds series

This paper provides an overview of prospectus disclosures as they apply to tokenised funds as at June 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

³ HM Treasury: UK regulatory approach to cryptoassets and stablecoins: Consultation and call for evidence (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/950206/HM_Treasury_Cryptoasset_and_Stablecoin_consultation.pdf)



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