Fund tokenisation

A closer look at existing structures and the road ahead

October 2024

This briefing explores tokenisation structures in a funds context. We start by looking at existing implementations, and how different commercial objectives can affect the legal tokenisation structure. We then consider how tokenisation structures may evolve in the future, and some of the legal and regulatory hurdles that would need to be overcome.

Tokenisation structures

Fund tokenisation involves the issuance (or 'minting') of a digital token that represents an interest in a fund. This requires two separate elements to be wedded. First, the token itself must be issued, via computer code recorded on a DLT-based network. Second, rights must be attached to the token, such that the holder has some form of enforceable legal interest or entitlement in the fund, either by virtue of holding the token or as a secondary consequence of that holding. However, the precise way these two elements are combined can vary, which can result in materially different legal and/or regulatory consequences. We refer to the way in which these two elements are combined as the 'tokenisation structure'[1].

Existing implementations

Dozens of tokenised funds have been launched in recent years, each designed to leverage DLT to create operational and/or cost efficiencies. While the specific objectives of those funds can differ, several well-known

Key points:

- Funds can be tokenised in different ways, leading to different legal and regulatory consequences.
- In certain existing structures, the token can serve primarily as an operational tool that augments (but does not replace) the conventional structure of the fund.
- Future implementations may go a step further, by replacing the core holding structure with a DLT-based alternative.

1 Although we only consider the tokenisation structure of funds in this briefing, the concept is applicable to other types of financial instruments, particularly debt and equity securities. See ISDA's 'Guidance for memorandum of law examining the validity and enforceability of collateral arrangements using the ISDA model provisions for tokenized collateral' (May 2024).

implementations seek to achieve one of two specific commercial objectives, which we examine below:

1. Using tokenised money market funds as collateral

Money market funds ('MMFs') are a type of open-ended investment fund, backed by a portfolio of diversified, low risk, yield-bearing assets. MMFs are regulated investments and are typically used to manage investors' short-term liquidity needs. At present, however, if the holder of a conventional form MMF needs to fund a margin call in relation to their trading activities, that investor would typically redeem the MMF and post the resulting cash proceeds to the collateral receiver, rather than transferring the MMF units or shares themselves. In turn, the MMF manager would sell part of the MMF's investment portfolio, in order to fund the redemption request. This can amplify liquidity issues during periods of market stress.

Tokenising MMFs can help address these sorts of issues, by facilitating the transfer of MMFs as collateral. Several tokenisation platforms have been established for this purpose – and to facilitate collateral mobility more generally – often in connection with collateralising uncleared derivatives, repos or securities lending transactions.

Counterparties that exchange tokenised MMFs may also benefit from the advantages more typically associated with on-chain transfers – e.g. faster settlement speeds, which can facilitate intra-day exchanges and shorten counterparties' margin period of risk (thus reducing the overall amount of margin or capital required in relation to the position)[2]. Regulatory reform may be needed to support further development in this area, however.

From a structuring perspective, arrangements designed to facilitate the transfer of MMFs as collateral lend themselves more readily to private DLT-based networks, managed by an identifiable system operator. For illustrative purposes, a service of this type could broadly work as follows:

- The counterparties accede to a platform rulebook alongside the system operator and any relevant custodian(s). The platform rulebook governs the relationship between the parties and the rights attaching to each token.
- A token is minted on the DLT-based network, representing the collateral provider's entitlement to a conventional-form MMF (or other collateral asset) that is held by a designated custodian.
- Upon the transfer of the token from the collateral provider to the collateral receiver, the collateral receiver becomes entitled to the underlying MMF being held by the designated custodian, as opposed to the collateral provider.

In this sort of tokenisation structure, the token represents a custody entitlement. The MMF unit or share itself continues to exist in conventional form, as the tokenisation takes place at a lower tier of the custody chain (in fact, it may be possible to tokenise an MMF share or unit without the underlying issuer knowing about the existence of the token). This more limited function should be taken into account when considering the regulatory classification of the token, although this would need to be considered case-by-case[3].

2. Using tokenised funds to access on-chain capital

Until recently, investors that regularly deal in crypto or digital assets are faced with a somewhat binary choice when seeking to manage their cash or cash-equivalent liquidity: either invest in stablecoins that do not pay interest, or conventional 'off-chain' assets which require access to traditional custody and settlement infrastructures. Tokenised funds offer a third way, by giving investors access to low risk, yield generating opportunities while remaining 'on-chain'.

2 See 'Money Market Funds and tokenisation: Collateral opportunities', Investment Association (March 2024).
3 For example, several jurisdictions now have regulatory frameworks that apply to "cryptoassets" or "virtual assets" which, at least on their face, could be construed broadly and capture most (if not all) digital tokens. These sorts of rules should be considered alongside conventional financial markets regulations that can apply to funds.

These sorts of tokenised funds have a very similar commercial profile to the tokenised MMFs being used as collateral, as both types of fund will invest in low risk, yield-bearing assets (e.g. U.S. treasuries). The structuring of this second type of tokenised fund will likely differ, however. This is because the token is being minted by the fund itself, rather than the system operator at a lower level of the custody chain. For illustrative purposes, this type of tokenised fund may broadly work as follows:

- The fund maintains a conventional, off-chain shareholders register which records the investors that hold interests in the fund.
- The fund mints tokens representing each investors' shareholding, which could be on a public DLT-based network that investors can access directly (or via a custodian), without acceding to a platform rulebook.
- If the token is transferred via the public DLT-based network, the fund's transfer agent will update the off-chain shareholder register to reflect that transfer. For KYC/AML purposes, on-chain transfers may only be permitted to network addresses that have been 'whitelisted' by the transfer agent in advance.

Ownership of legal interests in the fund is thus determined by reference to the entries made in the conventional off-chain shareholder register, rather than by reference to control of the token. This can have an important bearing on the regulatory treatment of the fund interests, as well as their use in collateral arrangements.

The examples referenced above are non-exhaustive. Indeed, tokenised funds have been established for many other reasons, including for reasons entirely distinct to those described above – for example, to automate certain processes via smart contracts, and/or to introduce cost savings that allow for lower minimum investment thresholds. We have not outlined the tokenisation structures associated with those types of funds in this briefing.

3. Future implementations

The tokenisation structures of the two examples described above share one core similarity – that is, the token serves primarily as an operational tool that augments (but does not replace) the conventional holding structure of the fund. As a result, those tokenised funds continue to function in much the same way as a traditional fund in some respects, at least from a legal perspective.

Future implementations may go a step further, by replacing the core holding structure with a DLT-based alternative. This type of digitally native fund poses several additional challenges, however. We describe two of those challenges below:

- Regulation: A digitally native fund will, in principle, be subject to the same regulatory standards as a conventional fund. The regulatory requirements that apply to the fund, the fund manager and any depositary will largely depend on the legal form of the fund and the jurisdiction in which it is established. In many jurisdictions, legislation has not yet been updated to facilitate DLT-based systems specifically. This may cause friction for digitally native funds that are seeking to comply with the relevant rules. For example, legislation may require a fund manager or depositary to maintain a register of the fund's shareholders or unitholders, and for that register to comply with certain minimum standards. If a public DLT-based system is being used as the register of shareholders or unitholders, however, the fund manager may struggle to demonstrate that it can update and/or correct the register, as envisaged in the rules, unless the DLT-based system accommodates some sort of override function. Similarly, rules that require the shareholder or unitholder register to be capable of being reproduced in legible form, or be available for inspection, will need to be considered. It is not readily apparent that DLT-based systems comply with these sorts of rules without specific adaptation. Funds may also take a wide variety of legal forms – e.g. limited partnerships, in

addition to unit trusts and corporate vehicles – which engage different rules.

The regulatory issues outlined above are particularly relevant to digitally native funds. This is because, as noted previously, no conventional 'off-chain' shareholder register (which will likely comply with the relevant rules) is being maintained in parallel to the on-chain records, as is the case in the tokenisation structures outlined previously. These issues have, however, been considered in similar contexts, notably by the UK Jurisdiction Taskforce in relation to equity securities subject to the Companies Act 2006 (which contains rules analogous to those outlined above)[4]. In many cases, regulatory issues can be overcome through appropriate structuring, if identified at an early stage. In other cases, regulatory barriers could be addressed by participating in regulatory sandboxes[5] (which enable certain rules to be relaxed).

- Conflict of laws: Another issue that arises in relation to tokenised funds is their treatment under conflict of laws rules – that is, the rules that determine which laws should apply to a given issue, in cases where more than one jurisdiction is potentially relevant. Conflict of laws rules can have significant commercial consequences given their influence on a variety of legal issues, and should thus be borne in mind when considering a fund's tokenisation structure. For example, English conflict of laws rules traditionally dictate that questions relating to the rights or entitlement to property should be governed by the law of the place in which the property or claim to property is situated (the lex situs) rather than the governing law of the relevant contract. This can have a bearing on determining whether a valid transfer of interests has taken place, amongst other things.

  The question, then, is how to apply conflict of laws rules to tokenised funds, when the ledger on which the fund interests are recorded and transferred uses DLT and may not therefore be said to be located in any identifiable location in the same way as a conventional fund (where the lex situs is often determined by reference to the location of the fund's shareholder or unitholder register). While this issue is relevant for the existing tokenisation structures outlined above, it is even more significant for digitally native funds where there is no parallel off-chain register that underpins any legal analysis.

  For these reasons, parties designing a digitally native fund may wish to consider the conflicts of law position at an early stage, and potentially structure the arrangements (by using a private DLT-system and/or embedding a control mechanism) so there is less or no ambiguity as regards which laws will apply to a given issue. If they do not, then investors and other participants may not have sufficient certainty in relation to how a particular legal issue would be resolved, potentially undermining confidence in the fund structure. Market participants may wish to monitor developments in this area, particularly the UK Law Commission's consultation[6].

There are a host of related issues that would need to be considered when establishing a tokenised fund, including the pros and cons of using a private or public DLT-based network, the interoperability issues associated with the former type of network, and how cash is to be represented in the system (i.e. whether and how a digital solution is to be used). These issues are applicable to other digital assets projects, and are not specific to funds.

Our offering

Simmons & Simmons LLP are a market leader in fund formation and emerging technologies. If you would like to discuss any of the issues raised in this briefing, please contact one of the lawyers listed on the following pages.

This briefing should not be construed as legal advice. Readers are advised to speak to their legal counsel before taking action in relation to any of the matters described above.

4 See 'Legal statement on the issuance and transfer of digital securities under English private law', UK Jurisdiction Taskforce (February 2024).
5 For example, the UK's Digital Securities Sandbox, which was launched on 30 September 2024.
6 See 'Digital assets and ETDs in private international law: Call for Evidence', UK Law Commission (February 2024).

Author

Oliver Ward
Managing Associate, Financial Markets
T +44 20 7825 4703
E oliver.ward@simmons-simmons.com

Contacts

United Kingdom

George Morris
Partner, Digital Business
T +44 20 7825 4046
E george.morris@simmons-simmons.com

John Dooley
Partner, FS Funds
T +44 20 7825 4308
E john.dooley@simmons-simmons.com

Rosali Pretorius
Partner, FS Regulatory
T +44 20 7825 4187
E rosali.pretorius@simmons-simmons.com

Devarshi Saksena
Partner, FS Funds
T +44 20 7825 3255
E devarshi.saksena@simmons-simmons.com

David Williams
Partner, FS Funds
T +44 20 7825 4150
E david.williams@simmons-simmons.com

Charlie Vermeylen
Partner, FS Funds
T +44 20 7825 4090
E charles.vermeylen@simmons-simmons.com

Catherine Weeks
Partner, FS Regulatory
T +44 20 7825 3940
E catherine.weeks@simmons-simmons.com

Marcin Perzanowski
Partner, Structured Finance & Derivatives
T +44 20 7825 3616
E marcin.perzanowski@simmons-simmons.com

Ireland

Niamh Ryan
Partner, Financial Markets
T +353 1266 1115
E niamh.ryan@simmons-simmons.com

James McKnight
Partner, Financial Markets
T +353 1266 1122
E james.mcknight@simmons-simmons.com

Luxembourg

Cathrine Foldberg Møller
Partner, Financial Markets
T +352 26 21 16 19
E cathrine.foldberg-moller@simmons-simmons.com

simmons-simmons.com

Italy

Ugo Malvagna
Counsel, Financial Markets
T +39 02 7250 5510
E ugo.malvagna@simmons-simmons.com

Singapore

Jek Aun Long
Partner, Financial Markets
T +65 6831 5 591
E jek.aunlong@simmons-simmons.com

Benedict Tan
Partner, Financial Markets
T +65 6831 5 594
E benedict.tan@simmons-simmons.com

Sonia Lim
Partner, Financial Markets
T +65 6831 5 601
E sonia.lim@simmons-simmons.com

Hong Kong

Ivy Yam
Partner, Financial Markets
T +852 25838 415
E ivy.yam@simmons-simmons.com

Kenneth Hui
Partner, Financial Markets
T +852 2583 8386
E kenneth.hui@simmons-simmons.com

Middle East

Adam Wolstenholme
Partner, Financial Markets
T +971 4 7096 648
E adam.wolstenholme@simmons-simmons.com