

On 2 November 2023, shortly after the speech made by Ms. Julia Leung, Chief Executive Officer of the Securities and Futures Commission (the "**SFC**"), at the 2023 Hong Kong Fintech Week, expressing the SFC's full support on "*continued experimentation with tokenisation in the financial markets*", but warning about managing risks arising from utilisation of the new technology, the SFC issued two highly anticipated circulars on tokenisation, being:

- the [Circular on intermediaries engaging in tokenised securities-related activities](#) (the "**Tokenised Securities Circular**"), which identifies new risks associated with tokenisation, and provides guidance to licensed intermediaries in addressing and managing such risks. This circular allows retail access to the distribution and marketing of "Tokenised Securities" and supersedes the [Statement on Security Token Offerings](#) dated 28 March 2019 (the "**Statement on Security Token Offerings**"); and
- the [Circular on tokenisation of SFC-authorized investment products](#) (the "**Tokenised Investment Products Circular**"), which sets out the requirements and additional safeguards under which the SFC would consider in allowing tokenisation of investment products authorised by the SFC under Part IV of the Securities and Futures Ordinance (Cap. 571) (the "**SFO**") for offering to the public in Hong Kong (primary dealing).

The two circulars demonstrate a shift in attitude by the SFC since the Statement on Security Token Offerings, where security tokens were considered as "complex products" requiring additional investment protection measures which should only be offered to professional investors. This shift is partly in response to the market's heightened interest in tokenisation, as well as the Government's bigger initiative to establish Hong Kong as Asia's crypto hub, as emphasized in the 2023 Hong Kong Fintech Week. In addition, the SFC recognises the potential benefits of tokenisation to the financial markets, particularly in increasing efficiency, enhancing transparency, reducing settlement time and lowering costs. However, new risks are associated with the use of this technology.

In fact, in the past years, tokenisation has been explored in Hong Kong. For instance, in 2022, the Hong Kong Monetary Authority (the "**HKMA**") launched the pilot project "Project Evergreen" for the Government to make its first tokenised green bond offering of HK\$800 million in February 2023. The full cycle of the bond offering

(covering primary issuance and settlement, coupon payment, secondary trading settlement and maturity redemption) was digitalised and performed on a distributed ledger technology ("**DLT**") network. Further, in September 2023, the first real estate security token offering was launched by Tykhe Capital in Hong Kong. The funds raised were used to acquire a five-unit retail property in Prince Edward, and professional investors holding the tokens (the Prince Tokens) are entitled to annual distribution of rental income generated from the property and future appreciation of the property's value.

### What is Tokenisation?

There is no statutory definition of "tokenisation". However, according to the SFC, "tokenisation" generally involves the process of recording claims on assets that exist on a traditional ledger onto a programmable platform, which includes the use of DLT in the security lifecycle. This can be seen as digital record-keeping with integration of rules and logic governing the transfer process for the asset. One type of DLT is blockchain technology.

In respect of "tokenisation of investment products", the SFC described it as the creation of blockchain-based tokens that represent or aim to represent ownership in an investment product. The tokenised product can then be recorded digitally on the blockchain offered directly to end-investors, distributed by SFC-licensed intermediaries, or traded among the blockchain participants where allowed.

### The Tokenised Securities Circular

The SFC notes in the Tokenised Securities Circular that many intermediaries have already been experimenting the tokenisation of securities, such as dealing in or advising on tokenised securities, issuing and distributing tokenised funds, managing funds investing in tokenised securities and trading tokenised products on virtual asset trading platforms ("**VATPs**"). As such, the SFC considers it suitable to provide more guidance on tokenised securities-related activities in order to clarify regulatory expectations and provide regulatory certainty.

At the outset, the SFC distinguishes two types of securities involving tokenisation, being:

- "**Digital Securities**": Digital Securities are "securities" as defined in the SFO that utilise DLT or similar technology in their security lifecycle, which may or may not be traditional financial instruments. Digitalised Securities (which are not Tokenised Securities) may be securities existing exclusively on a DLT network

with no links to extrinsic rights or underlying assets and have no controls to mitigate the risks that ownership rights may not be accurately recorded, which may amount to a collective investment scheme under the SFO ("CIS"). For example, they may include tokenisation of fractionalised interests in real world or digital assets such as artwork or land in a manner different from a traditional fund (amounting to a CIS) or tokenisation of a profit sharing arrangement which is not in the form of traditional securities; and

- **"Tokenised Securities"**: Tokenised Securities are a subset of "Digital Securities". They are traditional financial instruments (e.g. bonds or funds) that are "securities" as defined in the SFO which utilise DLT or similar technology in their security lifecycle. Their nature are fundamentally traditional securities with a tokenisation wrapper.

- the public offering of securities, including the prospectus regime under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (the "**C(WUMP)O**") and the offers of investments regime under Part IV of the SFO (the "**Public Offering Regimes**"); and
- the conduct of intermediaries engaging in securities-related activities.

We will first consider the SFC's guidance in relation to Tokenised Securities-related activities before moving on to the broader Digital Securities-related activities.

Tokenised Securities-related activities

As noted above, Tokenised Securities are fundamentally traditional securities with a tokenisation wrapper.

Accordingly, intermediaries are required to comply with existing legal and regulatory requirements governing the traditional securities markets, which apply to Tokenised Securities, in particular those relating to:

In addition, intermediaries need to manage the new risks arising from the additional tokenisation wrapper using DLT networks, such as ownership risks (e.g. transfer and recording of the transfer of ownership interest relating to Tokenised Securities) and technology risks (e.g. forking, blockchain network outages and cybersecurity risks). The risks involved will vary depending on the type of DLT network used. The SFC flagged Tokenised Securities in bearer form issued using permissionless tokens on open, public networks that do not restrict access of privileges and have characteristics of decentralisation, pseudonymity and large-scale user base (i.e. public-permissionless networks), to possibly be exposed to heightened cybersecurity risks, and higher exposures to money laundering and know-your-client issues.

In view of the need to manage the new risks, the SFC provides guidance to intermediaries engaging in Tokenised Securities-related activities, as summarised in the table below.

Area	Summary of additional guidance / safeguards to address new risks associated with tokenisation
<b>General</b>	<ul style="list-style-type: none"> <li>• Intermediaries should have necessary manpower and expertise to understand the nature of the Tokenised Securities-related activities engaged (including the new risks and manage such risks).</li> <li>• Intermediaries should act with due skill, care and diligence to identify key features and risks of the Tokenised Securities.</li> <li>• Intermediaries should perform due diligence on the underlying product (e.g. bond or fund) being tokenised, as well as the technology involved in the tokenisation.</li> </ul>
<b>Issuance of Tokenised Securities</b>	<ul style="list-style-type: none"> <li>• Intermediaries remain responsible for the overall operation of the tokenisation arrangement (despite outsourcing to third party vendors/service providers).</li> <li>• In assessing risks related to the technical and other aspects of Tokenised Securities, intermediaries are suggested to take into account the non-exhaustive list of factors set out in <a href="#">Part A of the Appendix to the Tokenised Securities Circular</a>, including experience of third party vendors/service providers used in the tokenisation process, smart contract deployed, robustness of the DLT network, data privacy risks and enforceability of the Tokenised Security.</li> <li>• Intermediaries should consider appropriate custodial arrangements with regard to the features and risks of the Tokenised Securities. For bearer form Tokenised Securities using permissionless tokens on public-permissionless networks, intermediaries should also take into account additional considerations set out in <a href="#">Part B of the Appendix to the Tokenised Securities Circular</a>, including experience, financial resources, conflicts of interest management, internal policies, systems, controls, security of the custodial facility of the custodian.</li> </ul>

<b>Dealing in, advising on, or managing portfolios investing in Tokenised Securities</b>	<ul style="list-style-type: none"> <li>• Intermediaries should conduct due diligence on issuers and their third party vendors/service providers involved in the tokenisation arrangement, as well as the features and risks arising from the tokenisation arrangement.</li> <li>• Further, intermediaries should understand and be satisfied with controls implemented by issuers and related parties in managing ownership and technology risks.</li> </ul>
<b>Information for clients</b>	<ul style="list-style-type: none"> <li>• Intermediaries should make adequate disclosure of relevant material information specific to the Tokenised Securities (including the risks associated) and on the tokenisation arrangement.</li> <li>• Examples provided by the SFC include whether off-chain or on-chain settlement is final, any limitations imposed on transfers of the Tokenised Securities, whether a smart contract audit has been conducted, key administrative controls and business continuity planning for DLT-related events, and custodial arrangements.</li> </ul>
<b>Complex product categorisation</b>	<ul style="list-style-type: none"> <li>• The SFC no longer takes a blanket approach in treating all Tokenised Securities as "complex products" – superseding the Statement on Security Token Offerings.</li> <li>• Instead, a "see-through" approach is adopted in assessing complexity. Whether a Tokenised Security is a complex product or not is based on an assessment of the complexity of its underlying traditional security, having regard to factors set out in: <ul style="list-style-type: none"> <li>➢ Chapter 6 of the <a href="#">Guidelines on Online Distribution and Advisory Platforms</a>;</li> <li>➢ paragraph 5.5 of the <a href="#">Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission</a>.</li> </ul> </li> </ul>
<b>Professional investors (PI)-only restriction</b>	<ul style="list-style-type: none"> <li>• As Tokenised Securities are fundamentally traditional securities with a tokenisation wrapper, there is <u>no</u> need to impose a mandatory PI-only restriction.</li> <li>• The requirements of the Public Offering Regimes continue to apply when offering Tokenised Securities to the public in Hong Kong. Where an offer of Tokenised Securities is not authorised under Part IV of the SFO or has not complied with the prospectus regime, they can only be made to PIs or pursuant to any applicable exemptions under the Public Offering Regimes.</li> </ul>
<b>Fund managers managing portfolios which may invest in Tokenised Securities</b>	<ul style="list-style-type: none"> <li>• The SFC has clarified that the "de minimis threshold"<sup>1</sup> only applies to "virtual assets" as defined under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615). Accordingly, fund managers managing portfolios investing in Tokenised Securities which meet the "de minimis threshold" are <u>not</u> subject to additional requirements set out in the <a href="#">Terms and conditions for licensed corporations or registered institutions which manage portfolios that invest in virtual assets</a> (i.e. Appendix 7 to the <a href="#">Joint circular on intermediaries' virtual asset-related activities</a> dated 22 December 2023), unless those portfolios also invest in virtual assets meeting the "de minimis threshold".</li> </ul>
<b>VATP operators licensed by the SFC and the applicable insurance/compensation arrangement</b>	<ul style="list-style-type: none"> <li>• VATP operators are required to put in place a compensation arrangement approved by the SFC to cover potential loss of security tokens in compliance with the <a href="#">Guidelines for Virtual Asset Trading Platform Operators</a> (which may be excluded on a case-by-case basis, upon application).</li> </ul>
<b>Notification and provision of information to the SFC</b>	<ul style="list-style-type: none"> <li>• Intermediaries interested in engaging in any activities involving Tokenised Securities should notify and discuss their business plans with their SFC case officer in advance.</li> </ul>

### *Digital Securities-related activities*

For Digital Securities-related activities, we summarise the SFC's guidance in the table below.

Area	Summary of additional guidance / safeguards to address new risks associated with tokenisation
<b>Public Offering Regimes</b>	<ul style="list-style-type: none"> <li>• The Public Offering Regimes continue to apply when offering to the public in Hong Kong.</li> </ul>

<sup>1</sup> "De minimis threshold" refers to the situation where (a) the stated investment objective of a fund is to invest in "virtual assets"; or (b) the intention of the fund is to invest 10% or more of the gross asset value (GAV) in virtual assets.

	<ul style="list-style-type: none"> <li>• Digital Securities cannot be offered to retail investors in breach of the Public Offering Regimes.</li> <li>• When distributed on an online platform, the Digital Securities must be properly designed and have appropriate access rights and controls to ensure compliance with applicable selling restrictions.</li> </ul>
<b>Sale of complex products requirements</b>	<ul style="list-style-type: none"> <li>• Given their bespoke nature, terms and features, Digital Securities which are not Tokenised Securities are likely to be regarded as "complex products".</li> <li>• Intermediaries distributing such Digital Securities should comply with requirements governing the sale of complex products, including ensuring suitability irrespective of any solicitation or recommendation.</li> </ul>
<b>Adequate systems and controls in place</b>	<ul style="list-style-type: none"> <li>• Intermediaries should implement appropriate adequate systems and controls to ensure compliance with applicable legal and regulatory requirements, as well as protect the interests of their clients.</li> </ul>
<b>Notification and provision of information to the SFC</b>	<ul style="list-style-type: none"> <li>• Intermediaries interested in engaging in any activities involving Digital Securities should notify and discuss business plans with their SFC case officer in advance.</li> </ul>

### The Tokenised Investment Products Circular

The Tokenised Investment Products Circular sets out the requirements and additional safeguards under which the SFC would allow tokenising SFC-authorized investment products under Part IV of the SFO to be offered to the Hong Kong public. This circular is to be read in conjunction with the Tokenised Securities Circular.

At present, the SFC considers it appropriate to allow primary dealing of tokenised SFC-authorized investment products (e.g. subscription and redemption) by adopting a "see-through" approach, as long as the underlying product meets:

- all applicable product authorisation requirements (e.g. the Code on Unit Trusts and Mutual Funds); and

- all additional safeguards to address the new risks associated with tokenisation.

On the other hand, given that secondary trading of tokenised SFC-authorized investment products would give rise to other complex considerations (e.g. maintaining proper and instant token ownership record, readiness of the trading infrastructure and market participants to support liquidity, and fair pricing of the tokenised products), the SFC will continue to engage with market participants in formulating appropriate measures to address such risks in the future.

The additional requirements for primary dealing of tokenised SFC-authorized investment products by product providers (the "**Product Providers**") are summarised in the table below.

Area	Summary of additional guidance / safeguards to address new risks associated with tokenisation
<b>Tokenisation arrangement</b>	<ul style="list-style-type: none"> <li>• Product Providers should: <ul style="list-style-type: none"> <li>➢ remain ultimately responsible for management and operational soundness of the tokenisation arrangement, and record keeping of ownership (despite any outsourcing arrangements);</li> <li>➢ ensure proper records of ownership are maintained, and the tokenisation arrangement is operationally compatible with service providers involved;</li> <li>➢ have appropriate measures in place to manage and mitigate risks relating to cybersecurity, data privacy, system outages and recovery, and maintain a comprehensive and robust business continuity plan;</li> <li>➢ use public-permissionless blockchain networks <u>only</u> where additional and proper controls are in place;</li> <li>➢ upon the SFC's request, confirm and demonstrate satisfactory management and operational soundness of the tokenisation arrangement, record keeping of ownership and the integrity of smart contracts (including obtaining third party audit or verification on these matters);</li> <li>➢ upon the SFC's request, obtain satisfactory legal opinion to support its application.</li> </ul> </li> </ul>
<b>Disclosure</b>	<ul style="list-style-type: none"> <li>• The offering documents should set out clearly: <ul style="list-style-type: none"> <li>➢ the tokenisation arrangement (in particular, whether off-chain or on-chain settlement is final);</li> </ul> </li> </ul>



	<ul style="list-style-type: none"> <li>➤ the ownership representation of the tokens (legal / beneficial title of the tokens and ownership of / interests in the product);</li> <li>➤ the associated risks with the tokenisation arrangement.</li> </ul>
<b>Intermediaries</b>	<ul style="list-style-type: none"> <li>• Distributors of tokenised SFC-authorized investment products should be regulated intermediaries.</li> </ul>
<b>Staff competence</b>	<ul style="list-style-type: none"> <li>• Product Providers should have at least one competent staff with relevant experience and expertise to operate and/or supervise the tokenisation arrangement, and manage new risks relating to ownership and technology.</li> </ul>
<b>Prior consultation or approval</b>	<ul style="list-style-type: none"> <li>• Prior consultation with the SFC is required for: <ul style="list-style-type: none"> <li>➤ introducing new investment products with tokenisation features with a plan to seek the SFC's authorisation;</li> <li>➤ tokenisation of existing SFC-authorized investment products (and may also require prior approval).</li> </ul> </li> </ul>

## Takeaways

The 2023 Hong Kong Fintech Week showcased the market's innovation and the Government's attitude in embracing financial technology moving forward, such as the HKMA's initiative to further explore use cases for DLT in capital markets and the continuation of the e-HKD Pilot Programme.

The SFC has emphasized that it is a firm believer in the responsible use of innovative technology to make the delivery of financial services more efficient, cost-effective and sustainable. Further, it strives to provide a technology-neutral regulatory environment that encourages innovation without compromising market integrity. As such, we expect the SFC to issue more guidance in the future to adapt to market demands as appropriate and identify new risks associated with fast-paced technological advancements, as evidenced by the Tokenised Securities Circular and the Tokenised Investment Products Circular.

In the two circulars, the SFC stresses the importance for Intermediaries and Product Providers to remain ultimately responsible for management and operational soundness of the tokenisation arrangement. With the new risks identified, Intermediaries and Product Providers are required to focus, in particular, on settlement finality, ownership, technology (including cybersecurity, system outage, possibility of undiscovered technical flaws) and custody, by understanding, managing and disclosing such risks. Where appropriate, they should consult the SFC.

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