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Dear Members,

We want to embrace the opportunities presented by innovation and encourage firms to take advantage of technological developments in their customers' best interests. We welcome this interim report from the Technology Working Group on fund tokenisation and are pleased to have worked constructively with participants on its development.

As we outlined in our [Asset Management Discussion Paper](#) earlier this year, although regulation does not generally dictate how technology is used, markets and firms can be made more effective where long-standing legacy processes are made more efficient through a combination of better use of technology and fresh thinking about how better investor outcomes can be achieved.

In response to the report, we set out below some of the rules that were considered in the development of the proposed 'baseline approach' set out in the interim report, so that members have a clear understanding of our interpretation of the relevant regulatory requirements. Inevitably, each particular model may differ from the baseline approach, so firms will need to undertake their own due diligence and may wish to seek independent advice on their particular circumstances.

An industry 'baseline approach'

The interim report outlines an approach that firms can follow under the existing legal and regulatory framework to develop and pilot models for fund tokenisation.

The approach involves replacing an authorised fund's traditional register of unitholders with tokens on a private permissioned (not publicly accessible) blockchain for which the authorised fund manager takes responsibility. It would have the following characteristics:

- The structure of the fund, including the existing roles of the parties, would remain unchanged.
- Settlement would be carried out in the usual way 'off chain', with no use of any form of digital money.
- The fund would be comprised of traditional assets.
- The fund would continue to provide a valuation point daily or on another timescale consistent with existing regulation and market practice.

As part of the development of the working group's report, the FCA and firms did not identify any obvious or significant barriers to this baseline approach in the FCA's rules that apply to authorised funds, as set out in the Collective Investment Schemes sourcebook (COLL), Investment Funds sourcebook (FUND) and the Client Assets sourcebook (CASS). The suggested approach does not change the structure of a fund or the responsibilities of its participants. For example, the FCA considers the following key regulatory requirements concerning the fund itself to be compatible with the approach.

Establishing and closing funds

Authorised funds can offer investors different classes of units or shares (COLL 3.3). These classes can have different costs and minimum investment levels and can be bought and sold using different currencies. If the AFM wanted to establish a class of tokenised units in a fund alongside existing units in standard form, the AFM would need to consider whether the tokenised class could prejudice the interests of unitholders in other classes.

On the winding-up or termination of a fund, all issued units or shares must be cancelled at the direction of the AFM and the proceeds distributed to investors (COLL 7.3, 7.4, 7.4A) or transferred to another regulated fund under an approved scheme of arrangement (COLL 7.6). Such transactions must be executable by the AFM alone without requiring a digital validation by the unitholder.

Register of unitholders

AFMs or depositaries must establish and maintain a register of unitholders, recording ownership of a fund's units. For example, COLL 6.4.4R requires a register for an authorised unit trust or authorised contractual scheme to be in the form of a 'document', but this is very broadly defined and could include a blockchain ledger. The rule also requires the person responsible for the register to make it available for inspection free of charge in the UK by a unitholder during office hours.

Communications with investors

A range of rules currently govern communications with investors. Before an investor buys units, a key investor information document must be provided, and the prospectus of the fund must be made available. Both these documents require disclosure of any risks associated with investing in the fund (COLL 4.2.5R and 4.7.2R), so an AFM would need to evaluate and explain any relevant material risks involved in holding units on a blockchain register.

The AFM would need to consider any possible significant impacts on its obligations when giving notices to registered unitholders (COLL 4.4.12R and 4.4.13R) and when providing other ongoing communications such as the annual and half-yearly reports of the funds (COLL 4.5), convening of extraordinary general meetings of unitholders (COLL 4.4), and approvals and notifications of fund changes (COLL 4.3).

Moving money into and out of funds

AFMs are required to follow rules that govern how money must move in and out of a fund. For example, there are rules in relation to creating and cancelling units (COLL 6.3) and dealing and settling investor sales and redemptions (COLL 6.2.16R). The baseline approach does not envisage that these processes would change, but the AFM would need to consider whether there might be situations where the interaction with a register held on a blockchain would require an operational change with regulatory implications. The AFM would also need to decide whether requirements for record keeping of dealing transactions (COLL 6.13) would be kept through the distributed ledger instead of, or as well as, in the traditional way.

Safekeeping of fund assets

A depositary of an authorised fund is required to follow certain provisions in COLL, FUND and CASS on safekeeping of the fund's assets (including record keeping). This includes the depositary keeping records as necessary to enable it at any time and without delay to distinguish safe custody assets held for one client from safe custody assets held for any other client, and from the firm's own applicable assets.

Depositaries must also continue to oversee certain aspects of the authorised fund manager's operation of a fund and monitor its cash flows, which might require them to have appropriate access to the ledger.

Custody of tokenised units

In circumstances where tokenised units fall within the regulatory perimeter (e.g. security tokens) firms carrying out regulated activities relating to custody of these assets are likely to be subject to CASS. The FCA is currently reviewing its custody rules in respect of security tokens – see Chapter 5 of FCA's Discussion Paper on regulating cryptoassets (DP23/4) for further details.

General organisational approach

In addition to the requirements set out above, AFMs must consider how the general requirements on firms to have effective systems and controls should apply to a tokenised fund. Our Senior Management Arrangements, Systems and Controls sourcebook (SYSC) sets standards which are designed to be adaptable to technological innovation, so we do not expect that specific new rules or guidance would be needed. For example, AFMs should consider how our operational resilience rules would apply to the technical infrastructure supporting the ledger itself, so that the firm has business continuity plans to address a situation where the underlying technology infrastructure does not operate as it should.

As technology develops, more advanced models may raise issues. For example, a model that involves a public permissionless blockchain (publicly accessible including to retail investors) may be incompatible with current rules that govern the accountability of certain participants, such as the AFM.

The FCA will keep its Handbook under review and will work with the government on any changes to legislation and regulation that may be required in the future.

We hope our view as stated above proves useful for firms looking to develop their own models. We look forward to continuing our close stakeholder engagement.

Yours sincerely

Camille Blackburn
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