

SFC outlines its expectations on tokenised products and services

Two circulars provide further regulatory guidance to licensed corporations on expectations for intermediaries

November 2023



On 2 November 2023, the Securities and Futures Commission (SFC) published two circulars which set out requirements for intermediaries conducting activities related to tokenised securities and investment products, respectively. These circulars are an important step in the development of tokenised securities and investment products in Hong Kong as they provide further clarity on the expected standards that should be followed.

Tokenisation of securities and investment products is a key step on the path to greater digitalisation of traditional financial products. It also provides an opportunity for market participants to introduce new business models that use blockchain technology, which can replace traditional (and costly) infrastructure and processes for financial products.

In this brief, KPMG outlines the proposed regulatory requirements, and key expectations set by the regulator for financial intermediaries dealing in tokenised securities.



1. [Circular on intermediaries engaging in tokenised securities-related activities | Securities & Futures Commission of Hong Kong \(sfc.hk\) \(First Circular\)](#)
2. [Circular on tokenisation of SFC-authorized investment products | Securities & Futures Commission of Hong Kong. \(Second Circular\)](#)

Key updates from the circulars

- SFC defines **Tokenised Securities** as “*traditional financial instruments (eg, bonds or funds) that are ‘securities’ which utilise distributed ledger technology (DLT), such as blockchain or similar technology in their security lifecycle*”. Tokenised Securities are a subset of a broader set of digital securities.
- **Digital Securities** that are not tokenised may be designed in more customised, innovative, or complex ways. Some may exist solely within a DLT network, without connections to external legal rights or underlying assets. They may lack sufficient controls to mitigate the risk that ownership interests are not properly maintained in the digital records. Digital Securities cannot be offered to retail investors in breach of the Public Offering Regimes. Where Digital Securities are distributed on an online platform, it must be properly designed and have appropriate access rights and controls to ensure compliance with selling restrictions which may be applicable to those Digital Securities.
- Since Tokenised Securities are “**fundamentally traditional securities with a tokenisation wrapper**”, existing regulatory expectations apply. For example, offerings of Tokenised Securities would be subject to the prospectus regime under the Companies (Winding up and Miscellaneous Provisions) Ordinance (Cap. 32), and offers of investment products come under Part IV of the Securities and Futures Ordinance.
- SFC clarified that **complex product** tagging of a Tokenised Security will be determined by assessing whether the underlying product (i.e. the bond or fund) is a complex product.
- SFC further clarified that if a virtual asset trading platform (VATP) can demonstrate to the SFC’s satisfaction that the risk of financial loss to its clients holding those Tokenised Securities can be effectively mitigated if the Tokenised Securities become lost, the VATP can exclude Tokenised Securities from the **compensation arrangement required under VATP guidelines**.

Overall standards expected of financial intermediaries involved in activities related to tokenised securities:



Issuance of Tokenised Securities

Where intermediaries issue Tokenised Securities, they remain responsible for the overall operation of the arrangement including the outsourcing of key operations to third parties. Thus, when assessing the risks, it is worth considering the list of non-exhaustive factors set out in Part A of the [Appendix](#) of the First Circular.

This extends to custodial arrangements. These have additional considerations for bearer form Tokenised Securities, which use permissionless tokens on public-permissionless networks as set out in Part B [Appendix](#) of the First Circular.

The SFC further stresses the relevance of its Second Circular on tokenising authorised financial products to issuance activities. Specifically, the SFC states that:

- a. primary dealing of tokenised SFC-authorized investment products is allowed
- b. secondary trading of tokenised SFC-authorized investment products would warrant more caution and careful consideration including 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
- c. prior consultation with the SFC is required for new investment products that have tokenisation features and where there are plans to seek the SFC's authorisation

Additional requirements for Tokenised Security providers:

- Maintain proper records of token holders' ownership interests in the product
- Ensure tokenisation arrangement is operationally compatible with service providers involved
- Manage and mitigate cybersecurity risks, data privacy, system outages and recovery, and maintain a comprehensive and robust business continuity plan
- Make sure not to use public-permissionless blockchain networks without additional and proper controls (for example, product providers to impose additional control by using a permissioned token)
- Upon SFCs request, demonstrate the management and operational soundness, obtain third-party audit or verification on governance and operations, and obtain legal opinion to support its application.



Dealing in, advising on, or managing portfolios investing in Tokenised Securities

Where intermediaries deal in, advise on, or manage portfolios investing in Tokenised Securities, they should **conduct due diligence** on the 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.

Moreover, intermediaries should understand and be satisfied with the controls implemented by the issuers and their third-party vendors/service providers to manage ownership and technology risks of the Tokenised Securities before they engage in related activities. Please refer to Parts A and B of the First Circular's [Appendix](#) for a non-exhaustive list of factors for consideration.



Disclosures

Intermediaries should ensure adequate disclosures of material information specific to Tokenised Securities are communicated clearly to the clients, details of which are found in Part E [Appendix](#) of the First Circular.

The offering documents of a tokenised SFC-authorized investment product should include:

- the tokenisation arrangement, and whether off-chain or on-chain settlement is final
- the limitations imposed on transfers of the Tokenised Securities (if any)
- whether a smart contract audit has been conducted before deployment of the smart contract (if any)
- key administrative controls and business continuity planning for DLT-related events
- the ownership representation of the tokens
- the associated risks of the arrangement, including cybersecurity, system outages, evolving regulatory landscape

How KPMG can help

KPMG is a market leader in supporting licensed corporations and virtual assets companies in various capacities including audit and advisory. A team of seasoned experts with deep knowledge of the VA space is ready to support you on the new SFC requirements.



Pre-Implementation

- Understanding the rules and managing rule ownership assignment
- Perform a gap analysis and readiness assessment your controls and processes against requirements and industry practices
- Assist you to perform the due diligence requirements as set out by the SFC on your partnered VA platforms and vendors



Implementation Support

- Support firms in implementing the SFC requirements in light of the regulated activity or activities you wish to carry out
- Perform regular assessments and health checks to ensure continued compliance with regulatory requirements, including cybersecurity and technology assessment, AML assessment and custody assessment



Business Support

- Business roadmap support and target operating model support under the new VA related activities
- Product and capabilities review and assessment against business objectives
- Notification and licensing support to the SFC
- IT and cyber security services in relation to virtual asset business
- AML and KYC services

Contact us



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