Tokenisation of Fund Units

MFSA Position Paper

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Disclaimer

This paper sets out the position of the Malta Financial Services Authority in relation to the use of tokenisation as part of the transfer agency process within the fund industry. Apart from the regulatory viewpoint, this paper does not constitute any financial, legal or professional advice on the use of tokenisation in transfer agency and, accordingly, the use of this information for such a purpose is without recourse to Malta Financial Services Authority and any of its officials for any loss, damage or liability sustained.

1. Introduction and Scope

a) Overview and Background

The asset management industry is an important pillar of the economic landscape as monies raised from investors are deployed into productive economic activities. This sector also provides investors with the opportunity to achieve diversification of wealth and the professional management thereof, with the aim of generating returns in a risk adjusted manner.

The European Union's regulatory framework is being enhanced and developed to regulate emerging technologies within the financial sector, *inter alia* through the enactment of the Markets in Crypto Assets (MiCA) Regulation and the DLT Pilot Regime. Such frameworks seek to ensure regulatory certainty, whilst addressing concerns around financial stability, market integrity, and consumer protection.

Against this backdrop, tokenisation represents a significant advancement in the global financial services industry, driving efficiencies, increasing transparency, and enhancing accessibility for investors worldwide. Through blockchain technology, traditional assets can now be digitally represented, facilitating seamless transfer and management across decentralised networks.

The scope of this paper is to set out MFSA`s position in relation to the tokenisation of shares or units issued by CISs from a transfer agency perspective.

b) Defining Tokenisation

A digital token provides a representation of any form of asset on a digital ledger that is **shared, trusted,** and **programmable**. Digital tokens can then be transferred, stored, or managed on a blockchain - a type of Distributed Ledger Technology (DLT) in which record of transactions and their details are decentralised and shared simultaneously across multiple locations and nodes within a computer network. Furthermore, since blockchains operate through decentralised networks, they eliminate the need for a central authority or an administrative oversight, such that access to the network is available to the public (permissionless blockchain) or to a designated group of persons (permissioned blockchain).

Shared

To transfer tokens on a ledger, the ledger must be shared, meaning that the transacting parties can own shares / units recorded on the ledger and instruct the ledger to update ownership.

Trusted

For the ledger to be usable, transacting parties must trust it for ownership and transaction purposes.

Programmable

Programmability implies that the ledger stores code-based instructions (smart contracts) that can be used to create assets (shares/ units) or financial applications.

Tokenisation can occur in various forms. Digital tokens may be created through the issuance of new tokens directly on a shared, programmable, and trusted ledger. Such tokens are referred to as "native" because they exist solely on the ledger. Alternatively, "non-native" tokens are digital tokens representing existing assets outside the ledger, such as financial assets held by a custodian.

In the context of Collective Investment Scheme (CIS) shares/ units, tokenisation involves transforming traditional assets (shares or units), into digital representations (or "digital assets"). These digital assets can be easily traded, shared, or owned in fractional portions on digital platforms. It is not the purpose of this MFSA Position Paper to cover the entire process of trading; however, it is intended as a first step, to cover the maintenance of the share register in a tokenised manner. Tokenisation of CIS shares or units may be achieved by enabling CISs to issue shares or units as digital assets, rather than in a more traditional dematerialised or registered form.

The tokenisation of CIS shares or units represents a step towards digitising the asset management industry, marking the shift from a dematerialised record of units/shares held to digital assets. However, this development does not alter the overarching regulatory obligations within the financial industry.

c) Tokenisation of CIS shares/units vs traditional shares/units issued by CISs

As previously stated, a digital token is an act or representation of an asset on a digital ledger that is **shared, trusted** and **programmable.**

A CIS can opt to issue shares or units in tokenised form to represent investors' interests in the said CIS. In this case, the ecosystem of the CIS remains unchanged even though some existing parties' roles will evolve. The transfer agent, for example, will maintain a central shareholder register on the blockchain.

The below diagram provides a comparative analysis of 2 share classes: one operating according to the standard traditional manner ("off-chain") and the second in tokenised form ("on-chain").
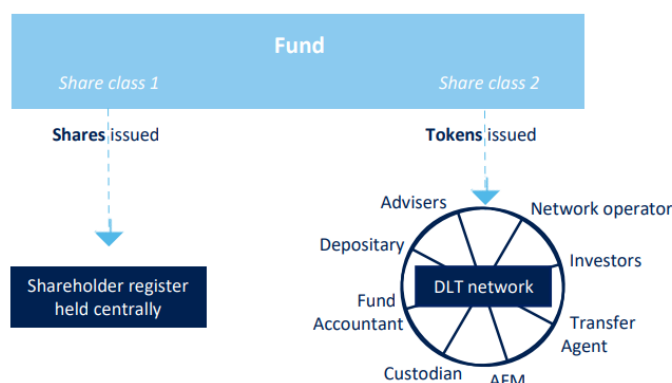
Source: Tokenization and Financial Market Inefficiencies (International Monetary Fund, January 2025)

In essence, in an off-chain model, it is only the fund administrator that has access to the shareholder register whilst in an on-chain model, there are various parties who can access the DLT network where the tokens are essentially held.

2. The MFSA's Position on Tokenisation of CIS Shares or Units.

Shares or units issued by CISs may be offered in a digital format, represented by a token. Different share classes within CISs will need to be represented by different digital assets, with each tokenised share class segregated accordingly and clearly distinguished from other dematerialised units.

Tokenisation of CIS shares or units falls outside the scope of MiCA, as these digital assets are classified as financial instruments and therefore fall within the scope of Markets in Financial Instruments Directive II (MiFID II). In fact, Article 2(4) of the MiCA regulation stipulates the crypto-assets that do not fall under MiCA, including financial instruments. ESMA have also issued guidelines on the conditions and criteria for the qualification of crypto-assets as financial instruments.

Accordingly, when a fund token is being marketed, only a MiFID authorisation would be required for the marketing of its units/shares. Given that only the format of the units issued is changed and on the basis of the fact that these tokenised instruments still fall under the definition of financial instruments under MIFID II, the conduct of business rules applicable to the distribution of such instruments contained in MIFID II and transposed in the Conduct of Business Rulebook would also apply.

The distribution process is contingent on the nature of the token's underlying assets. That said, the distributor must conduct a rigorous assessment to determine the applicable regulatory framework of the crypto-asset. If in doubt, the fund is to seek legal advice.

The MFSA would like to inform stakeholders that tokenisation of CIS shares or units is permitted for (a) licensed alternative investment funds; (b) licensed professional investor funds; (c) notified alternative investment funds; (d) notified professional investor funds and (e) UCITS.

Technology neutrality supports allowing UCITS to use tokenisation as long as the core regulatory objectives of liquidity, transparency and investor protection are preserved. The custodian plays an important role and CISs are to provide a description of how the custody of the assets will be maintained.

The transfer of CIS shares or units is subject to the prior approval of the CIS – which is only granted once the CIS approves the acquiring investor.

Fund Administrators:

Fund Administrators play an important role as they are responsible in managing the administration of the digitalised share class through the blockchain registry and smart contracts. The smart contract defines the operational framework of the fund including issuance of shares, subscriptions and redemptions, whilst the DLT register keeps record of the share ownership. That is, fund shares will be represented by security tokens within the blockchain in which the fund register will be maintained. Fund Administrators will also be required to conduct due diligence verifications both on the wallet and the wallet holder.

Whilst the base currency of a tokenised CIS share or unit shall remain Fiat currency, the following transparency measures and controls shall be considered.

a) **Competence Requirement**

The governing body of the CIS and its functionaries should have sufficient knowledge, experience and understanding of tokenisation and the underlying technology. They should be capable of carrying out their role in line with the standards prescribed in the respective regulatory frameworks.

b) **Disclosure Requirements**

The ability of the CIS shares or units to be in tokenised form will need to be clearly set out in the offering document and therefore inform the respective Function within the Authority. The offering document should include additional disclosures on the risks associated with tokenised shares or units and the creation and operation of digital wallets as well as information on the subscription and redemption procedures related to tokenised shares or units. Further details on these disclosures are outlined below.

As a minimum, the offering document must cover the following matters:

1. Information on AML/KYC requirements, particularly any variations in documentary checks compared to current requirements. Whether the sharing of AML/KYC checks is permitted amongst network participants, must be explicitly stated.

2. Information on arrangements for the issuance and redemption of tokenised CIS shares or units, including cut-off times and changes to settlement periods, if any.

3. Limitations, if any, on the transferability of tokenised CIS shares or units to third parties;

4. Information on the safekeeping arrangements applicable to tokenised shares or units; and

5. Identification of risks associated with tokenised CIS shares or units, including reliance on the chosen blockchain.

c) Risk Mitigation

Tokenisation carries certain risks, especially in relation to DLT, which must be mitigated through appropriate strategies. The following is a non-exhaustive list of the key risks and recommended mitigating arrangements, which should be stipulated in the offering documents as per (b) above.

1. **Distribution Ledger Design**: Information on the algorithm used should be obtained by the Fund/Fund Manager to better understand the chosen DLT network. Smart contracts should be developed according to recognised standards, with strategies in place for authorisation processes, service continuity, and dispute resolution.

2. **Key Management**: Processes must be defined for generating and delivering encryption key pairs to investors, protecting customer data linking to public keys, and addressing issues like lost or stolen keys. It is therefore essential to clearly communicate with the investors the importance of keeping passwords and keys safe as well as the potential consequences should these keys be lost.

3. **Privacy and User Identity**: Privacy rights must be assessed, with consideration for legal implications such as GDPR compliance. Measures should be taken to protect customer data, including elements that could link a customer identity to a public address as well as to define the data storage protocols within and outside the DLT environment.

4. **Recovery and Contingency Planning:** Detailed disaster recovery and business continuity plans must be documented and tested periodically, and these documents should include procedures for restoring the ledger in the event of a failure.

5. **Digital System Failure:** To mitigate the risks of digital system failures, incorporate, where applicable redundancy in the ledger infrastructure (e.g. backup nodes, geographically distributed servers). This ensures that even if one part of the system fails, the overall system continues to operate.

6. **Authentication and Authorisation:** Implement strong, multi-factor authentication (MFA) for users and systems accessing the ledger. This prevents unauthorised access and ensures that only validated entities interact with the system.

7. **Clear Communication of Risk**: Ensure all participants in the ledger system are aware of the risks they share and the operational impact of failures. This includes clear documentation on the roles and responsibilities of each party in maintaining security.

8. **Third-party Dependence Risk**: To address the operational risk associated with reliance on intermediaries (if any) in the tokenisation process, it is essential to establish clear protocols to ensure coordination.

9. **Governance Risks:** Clear roles, responsibilities, and decision-making protocols must be established.

Additionally, all participants in the ledger system should be aware of the risks they share and the operational impact of failures.

3. Conclusion

The contents of this position paper represent an initial step towards a broader adoption of tokenisation within Malta domiciled investment CISs. Traditional CISs structures often face certain constraints, particularly within the transfer agency function of their operations. Therefore, tokenisation could present an opportunity to address settlement inefficiencies and potentially pave the way for a more streamlined and cost-effective transfer agency operating model.