Tokenisation: Due diligence and design considerations

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Distributed ledger technology and tokenisation are poised to transform the financial markets. And, with several high-profile tokenisation platforms now moving from the build/test phase towards go-live, the future promised by such technologies is closer than ever.

Firms wishing to reap the benefits of tokenisation will likely need to join a tokenisation platform that provides the infrastructure in which tokens can be issued, settled and/or traded (depending on the design of the platform). Doing so is potentially fraught with risks, which need to be identified and understood by those that bear them. Firms should thus consider undertaking due diligence before joining a tokenisation platform, as is customary with traditional market infrastructures.

Introduction

This article outlines a selection of legal issues firms may wish to consider when conducting due diligence in respect of a tokenisation platform. Several of the points we raise below are equally relevant for firms seeking to design their own tokenisation platforms, although that is not our focus.

Characterisation

The first question for firms to consider concerns the characterisation of the tokens. In other words, what are the tokens from a legal perspective, and what property rights does holding the tokens confer? These questions are not straightforward and answering them will require analysing the design features of the tokens and the functionality of the tokenisation platform. One key threshold question is whether the tokens are best characterised as independent assets issued directly and exclusively on the underlying ledger ('digitally

What are tokens and tokenisation platforms?

Tokens are digital assets recorded on a distributed ledger or blockchain. Two broad types of tokens exist: digitally native tokens (which exist exclusively on the blockchain) and asset-linked tokens (which represent an asset held 'off-chain' in conventional form).

A tokenisation platform is a system that facilitates the issuance, settlement and/or trading of tokens, whether digitally native or asset-linked.

Key points:

- Tokenisation has a variety of benefits and is expected to usher in a new era of efficiency, transparency and security.
- Firms seeking to reap the benefits of tokenisation will likely have to join a tokenisation platform that provides the infrastructure through which tokens can be issued, settled and/or traded.
- Joining a tokenisation platform and dealing in tokens gives rise to a range of risks that firms may need to identify through due diligence. The same sorts of points are relevant to firms designing their own tokenisation platforms.

native') or serve only as an evidential record of assets held in conventional form elsewhere ('asset-linked'). Many different variants are possible, though[1].

The characterisation of the token, and the complexion of the link between the token and the off-chain asset (if applicable), will have several important consequences. For example, a token's characterisation will have a significant bearing on the nature of a firm's rights in the token and any linked asset(s), the token's transferability, the types of security interest that can be created in respect of the token, and the token's treatment upon insolvency. The regulatory treatment of the token will also rest on its legal characterisation.

Technology and functionality

Tokenisation platforms will invariably deploy new technology at their core. While participants may not need to fully understand (or be permitted to diligence) the platform's technology stack, it is important to understand certain key features, including whether the underlying ledger is private or public and permissioned or permissionless. Those design characteristics may impact the usefulness (and potentially, the value) of the tokens.

A related point is the range of functions supported by the platform and its interoperability with other systems. This will be a critical where the tokens have a cash element: for instance, where the tokens are settled against cash and/or where coupons or dividends arise in respect of the token. There are a range of potential solutions to these issues, such as platform coins or ensuring interoperability with traditional payment systems (and, in the longer term, using CBDC[2]) which need to be critically considered. Firms seeking to tokenise traditional assets will also need to know which assets the tokenisation platform supports and how post-trade processes are dealt with (e.g. voting), amongst several other factors. Firms may also want to understand whether the platform has made use of certain market standardisation initiatives[3] in its design.

Regulation

Regulatory considerations will understandably be high on the agenda for firms planning to deal in tokens and novel cryptographic technology. Two questions should be considered:

- First, how does joining the tokenisation platform and dealing in tokens interact with existing markets regulation (compared to dealing in conventional financial instruments, through traditional financial markets infrastructure)?
- Second, do any new and additional regulatory obligations arise by virtue of the firm joining the tokenisation platform and/or dealing in the tokens?

Answering these questions will require considering a range of existing markets regulation (e.g. CSDR, EMIR, MiFID, FSMA, CASS rules and the Prospectus Regulation, amongst others), as well as KYC and anti-money laundering rules and new crypto-specific regulation such as MiCA. The applicability of such regulation will vary case-by-case, depending on the characterisation of the token and the context in which the firm is dealing in them. For example, issuing a token will give rise to different regulatory issues when compared to transferring a token as collateral.

Holding structure and custody

A token can be held in a number of different ways, principally depending on whether it is digitally native or asset-linked. As part of their due diligence, firms should ensure they fully understand the relevant holding structure and their legal rights in relation to the tokens (and any linked assets), particularly the legal basis on which tokens are held and segregated by any custodian. Consideration should be given to the level of dependency on the platform operator and other intermediaries, together with any operational restrictions.

Firms should also consider whether the structure aligns with certain key legislation, including client money and asset segregation rules and any statutory frameworks designed to facilitate digital assets[4].

Default and insolvency

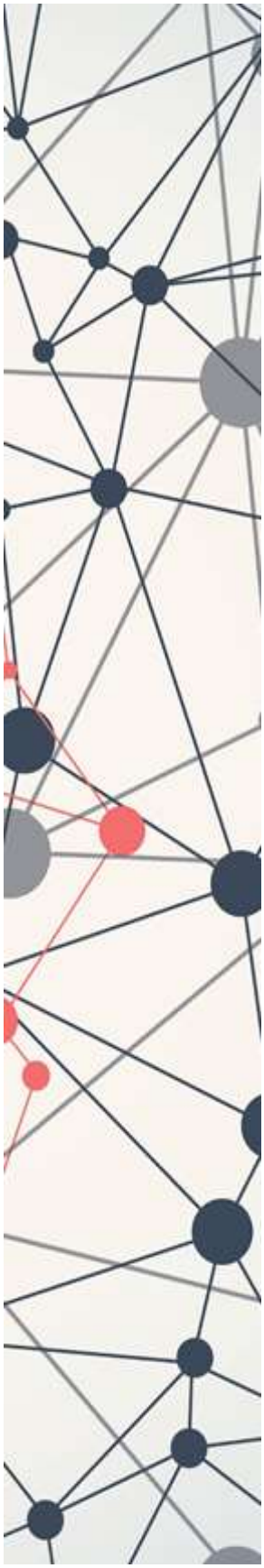
As with all financial market infrastructures, firms will need to carefully consider the consequences of a default occurring with respect to the platform

1 For example, a token may be 'backed' by another asset, as is the case for algorithmic stablecoins, without purporting to create legal rights in that asset. We have not sought to cover those sorts of tokens in this article. Whatever the structure, though, firms will need to clearly understand what the tokens represent and/or the off-chain assets linked to those tokens (including the form of any linked assets – e.g. whether they are dematerialised or held in registered or bearer form).

2 Certain high-profile test cases have used a wholesale central bank digital currency, issued by a central bank, to settlement payments. However, we do not expect CBDC to be used in commercial tokenisation platforms until the technology has matured.

3 For example, the Common Domain Model (CDM) developed by ISDA, ISLA and ICMA.

4 France, Luxembourg and Germany have all enacted legislation designed to accommodate digital assets, for example. If the tokenisation platform is intended to comply with that legislation, then any associated minimum requirements should be considered.



operator and, depending on the context, various other parties, e.g. the issuer of the tokens, custodians or intermediaries, or the party posting the tokens as collateral. The effect of the default will depend in part on the characterisation of the token from a property law perspective and its treatment under applicable insolvency law, as well as the holding structure and custody arrangements referred to above. Where the tokens form part of a collateral or security arrangement, firms should also consider the process for dealing with liquidation or enforcement.

Documentation

Acceding to a tokenisation platform in a financial markets context may involve signing-up to standardised terms (akin to exchange or clearing house rulebooks). Firms will need to scrutinise those terms and evaluate whether their rights and obligations therein match their expectations.

Firms will also need to consider how the tokens and/or platform affect any associated contracts. For instance, the terms and conditions of a token will need to take account of the tokenisation platform and its functionality. Where a token is being delivered in connection with a derivative, stock loan or repo, then firms may also need to consider amending the trading document(s) in place between the parties, e.g. ISDA, CSA, GMSLA or GMRA.

Conflicts of laws

The design of a tokenisation platforms can give rise to several potentially complex conflicts of laws questions; that is, questions about which jurisdiction's laws should apply to a given issue. This complexity stems from the decentralised, and potentially cross-border, nature of DLT-based ledgers and the difficulty in applying established legal principles[5] to the arrangement in question, particularly to systems without a central operator, locality or validation point. Firms should consider these points as part of their legal due diligence and the likelihood that the laws of another jurisdiction could apply.

Capital treatment

The capital treatment of DLT-based infrastructures

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5 For instance, proprietary issues affecting an asset are sometimes determined by reference to the law of the place in which the property is situated (the 'lex situs'). This can be difficult to apply in practice, however, particularly to intermediated financial instruments and DLT-based digital assets. The Law Commission has announced plans to investigate conflicts of laws issues in its forthcoming "*Digital assets: which law, which court?*" project. A consultation paper is expected in the second half of 2023.

has been the subject of renewed interest in recent months, owing to the finalisation of the BCBS' prudential standard on cryptoasset exposures[6].

Firms seeking to join a tokenisation platform should consider the likely treatment of the tokens from a capital perspective, including (for example) whether the tokens will fall within Group 1 or Group 2 under the BCBS standards, and the likelihood of the much-debated infrastructure risk add-on being applied.

Legal certainty

The law relating to digital assets is evolving rapidly. Although due diligence can clearly only be done at a particular point in time, firms should be conscious of which areas are most susceptible to change in the future. This is particularly acute where a firm's legal rights and/or regulatory responsibilities are not clear-cut, which may be the case where a firm's legal due diligence identifies points that have not been directly addressed by legislation or supported by recent judicial precedent.

Firms should thus be prepared to monitor legal developments and consider their impact from time to time.

Conclusion

Tokenisation is expected to transform the financial markets, and many hope it will usher in a new era of efficiency, transparency and security. The path forward is not without risks, however. Firms looking to join (or design) a tokenisation platform should be optimistic about its potential benefits but mindful of the risks. Taking concrete steps to identify and mitigate those risks will be a key concern for many, but are surmountable if properly managed.

Our offering

Simmons & Simmons LLP are a market leader in financial markets and FinTech. We combine our in-depth knowledge of traditional infrastructure with our cutting-edge digital assets experience to deliver effective solutions for our clients.

If you would like to discuss any of the issues raised in this article, please contact one of the lawyers listed further below.

This article 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.

6 See "Prudential treatment of cryptoasset exposures", published by the Basel Committee on Banking Supervision (December 2022).

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