

CHANCERY BAR ASSOCIATION JERSEY CONFERENCE

POMME D'OR HOTEL

THURSDAY, 7TH NOVEMBER 2019

THE WOBLING FUND: A CRYPTO CASE STUDY

Topic (1): The lessons to be learned from the Woodford fund situation in England

PETER DODGE

- 1 The ease with which an investment can be realised may be of little or no concern to the investor who intends to hold that investment indefinitely. Conversely, it may be of considerable concern to the investor who (i) may wish to realise that investment in order to (a) realise a profit or (b) avoid a further unrealised loss or (ii) *a fortiori* may need to realise that investment in order to meet some other commitment (i.e. a forced seller).
- 2 Liquidity is a multifaceted concept. In the context of funds, it may require consideration of:
 - (i) the ease with which an investor can realise his investment in the fund;
 - (ii) the effect of such realisation on the value of investments in the fund;
 - (iii) the ease with which the fund can realise its holding(s) of an underlying investment(s) (perhaps in order to fund the investor's realisation of his investment);
 - (iv) the effect of such realisation on the value of the underlying investment(s);
 - (v) the effect of a decline in value of the underlying investment(s) on the value of investments in the fund.
- 3 The conscientious investor, such as a trustee, cannot simply concern himself with the theoretical position in relation to factor (i), especially if he might be a forced seller at some point in the future. Which of the factors are engaged, however, and to what extent, will depend upon the fund structure.

The fund structures

4 We are told that the three “Jersey funds” in which the trustees invest are respectively (i) Wobling Fund LP (“**LP**”), a private fund; (ii) Wobling Fund Limited (“**Limited**”), a listed fund; and (iii) Wobling Global Fund Unit Trust (“**UT**”), an expert fund. The significance of this lies in the different mechanisms available to the trustees for realising their investments.

(a) *LP*

5 Those establishing a Jersey private fund can choose from a wide range of structures, e.g. companies, partnerships, unit trusts. LP is a limited partnership. It will thus be governed by the provisions of the Limited Partnerships (Jersey) Law 1994 (“**the LP Law**”) with its administration and operation being primarily regulated by the limited partnership agreement. The trustees’ investment may, as a matter of law, be theoretically realisable, by way, for example, of an assignment although, in practice, it may not be readily realisable at all. Article 21(1) of the LP Law provides as follows:

21 Assignments

- (1) A limited partner shall not assign his or her interest, in whole or in part, in the limited partnership unless –
 - (a) all the limited partners and all the general partners consent or the partnership agreement permits it; and
 - (b) the assignment is made in accordance with the terms of the consent or the partnership agreement, as the case may be.”

(b) *Limited*

6 The structure of a listed fund (such as Limited) is governed by paragraphs 1.1 and 1.2 of the Jersey Listed Funds Guide:

- 1.1 A Listed Fund is a *collective investment fund* that falls within Article 3 of the *Law* and is incorporated as a company in Jersey. It will be issued with a certificate under the *Law*.

1.2 A Listed Fund must:

1.2.1 Have a listing on a *Recognised Stock Exchange or Market*; and

1.2.2 Be a *Closed-ended Fund*.

7 The Glossary of Terms provides that:

“Closed-ended Fund	Means a fund which is not open for redemptions at the option of holders of securities.
Law	Means the Collective Investment Funds (Jersey) Law 1988, as amended from time to time.
Recognised Stock Exchange or Market	Means an exchange or market listed in Appendix 1, as amended from time to time.”

8 The list in Appendix 1 includes a wide range of exchanges or markets. It is reasonable to assume that trading volumes on those exchanges or markets may vary considerably.

9 By definition, therefore, the trustees are unlikely have the option of redeeming their shares of Limited. If they wish to realise their investment, they must attempt to sell their holding through the relevant exchange or market. How easy they will find this will depend upon the size of the market in the shares. They may find that they are driving down the price against themselves. However, there should be no effect on the value of the underlying investments held by the fund (i.e. its NAV) because the realisation by the trustees does not require the fund to realise any of its underlying investments. The effect of driving down the share price would, though, be to increase the discount to NAV applicable to any shares which the trustees may wish to retain.

(c) *UT*

10 The structure of an expert fund (such as UT) is governed by paragraphs 2.1 ad 2.2 of the Jersey Expert Fund Guide:

2.1 An Expert Fund may take any form recognised under the laws of Jersey. It will be issued with a certificate under the *Law*.

2.2 An Expert Fund may be an *Open Fund* or a *Closed Fund*.

11 The significance of the World Amelioration Organisation (“WAO”) being a supra-national body (in Jersey or elsewhere) lies in the fact that such an organisation falls within the definition of an “Expert Investor” in paragraph 1.5 of the Jersey Expert Fund Guide.

12 The Glossary of Terms provides that:

“Closed Fund	Means a fund which is not an <i>Open Fund</i>
Open Fund	Means a fund that is normally open for both subscriptions and redemptions at the option of <i>Unitholders.</i> ”

13 As a unit trust, UT is likely to be an Open Fund. It will have been established against the statutory background of the Trusts (Jersey) Law 1984 although, rather like LP, its administration and operation will be largely regulated by the trust instrument.

14 Being an open fund, if the trustees wish to realise their investment, they can request redemption. In accordance with paragraph 3.3 of the Jersey Expert Fund Guide (and the opinion of the JFSC as to what is material), the Offer Document should have contained information as to:

“3.3.7 The basis upon which dealing in the Expert Fund is to take place, if applicable;

...

3.3.9 The basis upon which the value of the Expert Fund is to be calculated and (in the case of an *Open Fund*) how the value of *Units* in the Expert Fund is to be determined;

3.3.10 The manner in which *Units* in the Expert Fund are to be created, issued and paid for and (in the case of an *Open Fund*) cancelled and redeemed”

15 Unlike in the case of a listed fund, a redemption request by the trustees would require the managers of UT to consider their ability to meet that request. They might hold sufficient cash or readily realisable underlying investments. If they require time to realise underlying investments, they may need to exercise a power to delay redemption. The effect of underperformance can be corrosive. Underperformance can cause investors to

request redemption. This may cause the fund to need to realise underlying investments (which may themselves have underperformed). The fund may find that it is driving down prices against itself. Declines in the value of the underlying investments may lead to a decline in the value of units in the fund (i.e. NAV) which may, in turn, fuel the perception of underperformance. In the case study, the initial redemption request (by WAO) appears to have been triggered by a combination of underperformance and the suspicion of criminality or fraud.

The Woodford affair

- 16 Liquidity is, of course, topical because of what has come to be known in the UK as “the Woodford affair”. Whilst this was the inspiration for those parts of the case study concerning liquidity risk, it must be emphasised that “the Woodford affair” has nothing whatsoever to do with other aspects of the case study (in particular, those involving discussion of criminality or fraud).
- 17 Woodford Investment Management Limited managed three funds, one of which was a quoted investment trust (i.e. akin to a Listed Fund). On 3rd June 2019, a letter was sent to all investors in one of the unitised funds informing them of suspension:

“LF Woodford Equity Income Fund (a sub-fund of LF Woodford Investment Fund, an Investment Company with Variable Capital) (the "Fund")

Link Fund Solutions Limited (“LFS”) as the Authorised Corporate Director of the Fund has, as of Monday 3rd June 2019, obtained the agreement of the Fund's Depositary to suspend dealing in shares in the Fund, with immediate effect and until further notice.

After consideration of all relevant circumstances relating to the Fund’s assets, we have, in conjunction with Woodford Investment Management Limited (“Woodford”), the appointed Investment Manager, come to the conclusion it is in the best interests of all investors in the Fund to suspend the issue, cancellation, sale, redemption and transfer of shares in the Fund.

Following an increased level of redemptions, this period of suspension is intended to protect the investors in the Fund by allowing Woodford, as previously communicated to investors, time to reposition the element of the Fund's portfolio invested in unquoted and less liquid stocks, into more liquid investments.

During the period that share dealing is suspended no requests to redeem, purchase or transfer shares in the Funds will be accepted. When LFS elects to resume dealing in the shares of the Fund, we will write to all investors informing them of this fact.

18 In due course, investors were informed that the fund was to be wound-up.

How realisable are UT's holdings of underlying investments?

19 Not surprisingly, UT was unable to meet the request by WAO for the redemption of 40 per cent of the issued units. In considering how to raise money in order to meet the unexpected \$5 million capital call, the trustees may be aware of the suspension of dealings. Suspension does not necessarily imply that the managers will not accept requests for redemption (such requests might, for example, be placed in a queue). Nor does it necessarily imply that the underlying investments are unrealisable or worthless. It may (as contemplated by the original Woodford letter from LFS) simply take some time to realise them, albeit possibly at disadvantageous prices.

20 We are told that the fund's portfolio is as follows:

	%
Listed securities	
LSE: Wobling House REIT plc (ownership of three rental properties occupied by Wobling Group companies)	5
NYSE Arca: Splosh Physical Rhodium ETF (owns physical rhodium)	5
TSX Venture Exchange: Dish Dash Dosh! Inc (investment and trading in Dosh!)	10
Unlisted securities	
BVI: Bish Bash Dosh! Ltd (investment and trading in Dosh!)	15
Government and other public securities	

Republic of Oceania 2.0% Innovative Finance Bond 2050 (denominated in Dosh!)	30
Republic of Oceania 2.5% Innovative Finance Bond 2060 (denominated in Dosh!)	5
Investment in other schemes	
LP/Limited/UT (as applicable)	10
Commodities	
Rhodium	10
Cash	
Dosh!	10
Total	100

- 21 Not least in order to meet potential redemptions, many open-ended funds would be likely to hold a certain amount of cash liquidity. Here, UT is treating Dosh! as cash. Since Dosh! has plunged in value (and may be a fraudulent construct), there are obvious doubts over whether UT could be said in any realistic sense to be holding cash at all (even leaving aside the global regulatory debate over whether so-called cryptocurrencies are properly regarded as currency or as more akin to assets such as commodities).
- 22 The case study raises the question of whether the trustees were well advised to invest in the Wobling funds (and, by implication, whether the managers of the Wobling funds were well advised to invest the property of the funds as they did). There is a distinction between the permissibility of an investment as a matter of law and the wisdom of making that investment (the latter being likely to require expert evidence of opinion).
- 23 The following principles in the Certified Funds Code could be relevant to the issue of whether the managers were well advised to invest the property of the funds as they did (or to hold liquidity in the form they did):
- “(2) A Fund must always act in the best interests of Unitholders (this includes an obligation at paragraph 2.9 to ensure appropriate due diligence is undertaken on the suitability of its investments).

- (3) A Fund must organise and control its affairs effectively for the proper performance of its activities and be able to demonstrate the existence of adequate risk management systems.
- (5) A Fund must maintain, and be able to demonstrate the existence of, both adequate financial resources and adequate insurance.”

24 Principle 6 (A Fund must deal with JFSC and other authorities in Jersey in an open and co-operative manner) is relevant in so far as it requires a fund, as soon as it becomes aware, to notify the JFSC of any “proposal to suspend or defer rights of redemption or trading of *Units*” (paragraph 6.7.9).

25 None of the Wobling funds is a Jersey Open-Ended Unclassified Collective Investment Fund (OCIF) offered to the general public. However, it might be instructive to compare UT’s portfolio with the investment limits set out in Appendix 1 (Investment Limits and Borrowing Powers) of the OCIF Guide. For a General Securities Fund, those limits include the following:

“Spread of Investments

- 1.2 The value of an *OCIF*’s holding of securities issued by any single issuer may not exceed 10 per cent of its total *net asset value*.
- 1.3 An *OCIF* may not hold more than 10 per cent of any class of security issued by any single issuer.

Unlisted Securities

- 1.4 The value of an *OCIF*’s holding of securities not listed or quoted on a recognised market may not exceed 15 per cent of its total *net asset value*.

Government and other public securities

- 1.5 Notwithstanding 1.2 and 1.3 of this Appendix up to 30 per cent of the total *net asset value* of the *OCIF* may be invested in *government and other public securities* of the same issue.

1.6 Subject to 1.5 of this Appendix, an OCIF may invest all of its assets in *government and other public securities* in at least six different issues.

Bank Deposits

1.8 Not more than 10 per cent of the NAV, or US\$1,000,000, or the equivalent in the base currency of the OCIF, whichever is the greater, should be kept on deposit with or on loan to any one person, or any connected company of that person unless that person is an *Approved Bank*, in which case the maximum may be 20 per cent of the NAV of the OCIF.

...

Investment in other schemes

1.18 The value of an OCIF's holding of *Units* or shares in other collective investment schemes may not in aggregate exceed 10 per cent of its total *net asset value*. In addition, the objective of such collective investment schemes may not be to invest primarily in any investment prohibited by this Appendix and where such scheme's objective is to invest primarily in investments restricted by this Appendix, such holdings may not be in contravention of the relevant limitation.

...

Real Estate Investments

1.20 An OCIF which is not a Real Property Fund (see Appendix 6), may not invest in any type of real estate (including buildings) or interests in real estate (including options or rights but excluding shares in real estate companies).

Commodities

1.21 Investment in commodities must be limited to gold, silver, platinum or other bullion and the value of an OCIF's holding of such physical commodities and commodity based investments (other than shares in

companies engaged in producing, processing or trading in commodities), may not exceed 20 per cent of the total *net asset value* of the *OCIF*.

Investment in Securities in which Directors/Officers have interests

1.24 An *OCIF* may not invest in any security of any class in any company or body if any director or officer of the manager owns more than 0.5 per cent of the total nominal amount of all the issued securities of that class, or, collectively the directors and officers of the manager own more than 5 per cent of those securities.

26 The Glossary of Terms provides that:

“Recognised Market	Means any stock exchange, over the counter market or other organized securities market that operates regularly and is open to the international public and on which such securities are regularly traded.”
--------------------	--

27 In comparing UT’s portfolio with the *OCIF* investment limits, the following observations might be made:

(1.2) Apart from Government and other public securities, the only holding of securities issued by any single issuer which exceeds 10 per cent of UT’s NAV is that of Bish Bash Dosh! Ltd.

(1.3) We do not know enough about the underlying investments to be able to comment on this.

(1.4) Each of the markets on which securities held by UT are listed (LSE, NYSE Arca and TSX Venture Exchange) falls within the definition of a Recognised Market. NYSE Arca (headquartered in Chicago) was formerly known as ArcaEx, merged with the NYSE in 2006 and now operates as a subsidiary of NYSE Group, Inc. The TSX Venture Exchange (headquartered in Calgary) was formerly known as the Canadian Venture Exchange and was created in 1999 by the merger of the Vancouver Stock Exchange (VSE) and the Alberta Stock Exchange (ASE). It might be

noted that, of these, only the LSE appears in Appendix 1 of the Jersey Listed Funds Guide, although the purpose of that appendix is rather different. At first sight, only 15 per cent of UT's portfolio is held in an unlisted security, although, for the other Wobling funds, a holding of units in UT would appear likely to be a holding of a security "not listed or quoted on a recognised market". The expression "securities" is not defined.

- (1.5) This paragraph is not expressed to be notwithstanding paragraph 1.4, although it may well be that the sovereign bonds are listed. Whilst there is nothing objectionable *per se* in a sovereign state borrowing in another currency, the notion of borrowing repayable in a cryptocurrency for a term of over 40 years might cause the raising of an eyebrow.
- (1.6) This would permit the investment of the additional 5 per cent in a government security of a different issue.
- (1.8) What invites comment here is that UT does not seem to have anything on deposit with anyone at all.
- (1.18) The crossholdings of other Wobling funds do not exceed 10 per cent of UT's NAV. The expression "collective investment schemes" is not defined and may bear a wider meaning than that of "Collective Investment Funds".
- (1.20) The holding of shares of Wobling House REIT plc is unlikely to engage this provision, these almost certainly being "shares in (a) real estate (company)" (although the expression is not defined).
- (1.21) There is no definition of "bullion" although platinum group metals such as rhodium would generally be regarded as precious metals and hence probably as "bullion". Whilst the price of rhodium has risen strongly in 2019 (from \$2,460 per ounce at the end of 2018 to \$5,355 on 5th November 2019), in an online article of 22nd March 2019, a market participant (Mr Hans-Guenter Ritter, global head of trading for Heraeus Precious Metals) was quoted as saying that, despite rhodium's rarity, it:

“falls under the radar (of investors) compared to palladium and gold due to its lack of market liquidity and very small market size. Very small investments can sometimes lead to meaningful movements in the price and while you are able to invest in rhodium, it may not be so easy to find a willing buyer when you want to exit.”

Code of Practice for Alternative Investment Funds and AIF Services Business (“the AIF Codes”)

- 28 The significance of the Wobling funds being marketed to investors in the UK and Luxembourg is that they are being marketed in territories which are currently member states of the EU (the future status of the UK is obviously uncertain).
- 29 It is beyond the scope of this short talk to consider the applicability of the AIF Codes to either (i) any of the Wobling funds (as AIFs) or (ii) their manager (as an AIFM). It might be noted, however, that the AIF Codes contain provisions on liquidity management (Article 16 of the Level 1 AIFM Directive). Paragraph 10.1 provides as follows:

“*AIFMs* shall, for each *Directive AIF* that they *manage* which is not an unleveraged closed-ended *Directive AIF*, employ an appropriate liquidity management system and adopt procedures which enable them to monitor the liquidity risk of the *Directive AIF* and to ensure that the liquidity profile of the investments of the *Directive AIF* complies with its underlying obligations.

AIFMs shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the liquidity risk of the *Directive AIFs* and monitor the liquidity risk of the *Directive AIFs* accordingly.”

PETER DODGE

Radcliffe Chambers
11 New Square
Lincoln’s Inn
LONDON
WC2A 3QB

7th November 2019

pdodge@radcliffechambers.com