

Snapshot: key considerations for crypto funds in the event of a crypto exchange collapse

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This snapshot is intended to highlight some important, high-level considerations for directors and managers of crypto funds during challenging times, in particular in light of the filing for Chapter 11 bankruptcy by FTX, which had been one of the largest crypto exchanges in the world.

Certain actions might be time-sensitive in order to avoid a run on the fund which could potentially, in the worst case, lead to an insolvency situation of the fund itself. Issues around striking a net asset value (**NAV**) and how to value assets trapped on the exchange are also pertinent as they impact the ongoing operations of a fund.

We consider some of the issues faced by crypto funds, in particular, open-ended crypto funds, and steps that might be taken to mitigate the risks a fund might face if it sees a rush for redemptions, as well as general considerations that would apply in the case of the winding-up of the fund or providing for its ongoing operation.

1. Valuation

For assets held in accounts or wallets maintained with a crypto exchange that faces liquidity issues (for the purpose of this article, the **impacted assets**) and where withdrawals or transfers are prohibited (or where such assets are dissipated following an alleged hack), fund managers and directors should discuss with their fund administrators and auditors as to how this will impact the valuation of the assets affected, and consequently the NAV of the fund. The valuation treatment should be agreed before the next valuation day (when the NAV of the fund will be struck).

The FTX saga has had a ripple effect in the market and so broader valuation issues may arise beyond the points raised around impacted assets and directors and fund managers should remain vigilant.

2. Restrictions on redemptions and gating

Investors in the fund may be losing confidence and seeking to redeem their investments (not just related to the situation regarding the exchange itself but also due to the consequential impact on the crypto market as a whole). However, in order for redemptions to be met, it is necessary for the fund to be able to strike a NAV and have sufficient liquidity to be able to pay out the proceeds of redemptions. Therefore, decisions have to be made as to how to value and deal with the impacted assets.

Where the NAV of the fund cannot be determined prior to the next valuation day or where a substantial part of the assets of a fund are traded on an exchange where trading is severely restricted or suspended, the fund managers and directors should consider whether a temporary suspension of the NAV calculation and dealings is warranted under the fund's constitutional documents and offering terms. Typically, fund directors and managers are given wide powers to declare a temporary suspension of the determination of the NAV, as well as subscriptions and redemptions of participating shares, under pre-defined circumstances.

Imposing such suspensions on the NAV and redemptions is a serious action because it also impedes the fund's ability to accept new subscriptions and may be unpopular with investors whose ability to make redemptions is then curtailed. However, directors of the fund have to consider the best interest of the fund and consider whether this would be a prudent option to take.

Given the severe implications on the ability of investors to redeem their investments, funds that declare suspensions should notify investors of the declaration (with details) as soon as practicable after the declaration has been made. It is also imperative for fund operators and managers to consider whether the fact that the fund has suspended redemptions needs to be reported to the relevant regulators (such as the Cayman Islands Monetary Authority should the fund be registered in the Cayman Islands).

Some but not all fund documents will allow for gating of redemptions. Where these mechanics are included in the fund documents, the directors have an ability to restrict redemptions on any redemption day to a specified percentage of the NAV of the fund. Those investors that have submitted redemptions but had their redemption request deferred might, subject to the fund documentation, have their redemptions preferred over newly submitted redemption requests. Therefore, activating the gating provisions can, of itself, trigger investors to consider submitting redemption requests to secure themselves in the line of priority.

3. Side pockets

For funds which include side-pocket mechanisms, subject to the offering terms (in particular, limits and restrictions regarding side pockets), impacted assets could be side pocketed, thereby suspending the redemption rights of the corresponding shares attributable to such side pocketed assets. This allows the fund to continue to strike a NAV on the remainder of its assets

and process subscriptions and redemptions, excluding the side pocketed assets.

4. Other options

Other options may be available depending on the fund documentation and circumstances of the fund. Restructuring options may also be considered such as synthetic side-pocket arrangements, whereby the impacted assets are transferred into a SPV established by the fund for these purposes, or to transfer impacted assets to a liquidating trust.

Due to the potentially significant impacts on funds and their investors, we recommend that directors take advice in a timely fashion.

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