THE INVESTMENT ASSOCIATION

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The Investment Association

Tokenised funds series Paper 4 – Disputes considerations

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The Investment Association in partnership with CMS

Tokenised Funds – Disputes considerations

About this paper

This is the fourth paper in the IA tokenised funds series in collaboration with CMS. In this paper we explore the dispute resolution considerations in the context of tokenised funds. The previous papers are available here.

1. Refresher – the concepts of tokenisation and tokenised funds

To summarise, a token is a form of cryptoasset. They can relate to cryptoassets, exchanges of information, payment processes or representation of assets. In each case they are virtual assets which use "tokens". These digital tokens can then be transferred, stored, or managed using distributed ledger technology ("DLT").

DLT is a digital ledger which records transactions and in which the transactions and their details are recorded in multiple places at the same time by different people. There is no central authority or administration functionality (i.e. it is decentralised), and the data can normally be publicly available and viewed, or private.

Tokens which represent traditional assets such as shares, debt or units in a fund, are known as security tokens and are issued through a security token offering ("STO"). The security token in turn represents the specific right, for example participation in an investment fund.

A tokenised fund, which may also be known as a digital fund or a BTF (blockchain-traded fund) is one where shares or units in the fund, or a feeder fund for it, are digitally represented and can be traded and recorded on a distributed ledger. It uses code to mimic the functionalities of a traditional fund and replaces shares or units with tokens. It is not a form of uncertificated security recorded by the fund itself, but by the DLT ledger. Because of this, the differences between investing in a fund and owning the tokens that represent shares or units in the fund are not substantial. However, the costs associated with maintaining investor registers, for example, including where there is secondary market trading, should be greatly reduced where ownership is represented using a token.

The parties involved in a traditional fund and a tokenised fund will also remain relatively unchanged, although there will need to be a network operator and the roles of some parties may evolve.

Further, each token may act as a database and therefore can store additional information which might otherwise be unavailable with a "traditional" security. For example, a security token can both indicate legal ownership and rights, whilst also supplying additional information such as ESG risks, AML & KYC and much more. This additional information can help measure the performance of the fund in line with its objectives and constitutional documents.

2. Why is dispute resolution important in the context of tokenised funds?

It has been found that one of the core challenges facing the expansion of tokenised funds relates to governance, rather than technical issues[1]. This is particularly relevant when looking at fully decentralised ledgers, as identifying the sole owner of the ledger may prove challenging. Further, in relation to permissionless DLTs, network participants can perform '51% attacks' if the majority disagree with the initial plan[2], raising the potential for fraudulent behaviour and class actions.

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[1] World Economic Forum: *Dispute Resolution for blockchain-based transactions* December 2020
[2] OECD: *The Tokenisation of Assets and Potential Implications for Financial Markets* 2020

These issues, combined with unforeseen, rapid technological advances in the DLT space, mean that parties involved in tokenised funds will inevitably be exposed to new legal risks and disputes.

In order to ensure the protection of the fund's value, it is therefore critical to utilise and establish a robust governance framework designed to manage the processes by which disputes are properly settled, combining both "on-chain" and "off-chain" dispute resolution mechanisms.

Having an accepted and respected method of dispute resolution is a key component to the growth of tokenised funds. Without this, it is likely that many funds will not function as well as those where dispute resolution is available, which will ultimately reduce its utility[3].

Legal status and characterisation of tokenised funds

Before considering the types of dispute resolution mechanisms that may be more appropriate for tokenised funds, it is critical to determine its legal classification, as well as how these funds are likely to be characterised from a regulatory perspective.

The Financial Conduct Authority has stated on many occasions that the financial services regulatory regime is "technology neutral". Therefore, similar to a regulated traditional fund, a regulated tokenised fund would also fall within the scope of the financial services regulatory perimeter. As such, in either case the fund and entities involved with the fund, such as the fund manager, will be subject to the UK regulatory regime.

Being able to establish tokens as "property" will allow for various rights and remedies to be available and ultimately aid the commercialisation of the tokenised funds. In addition, where smart contracts are used for transferring the tokens there will be questions about the legal status and enforceability of such contracts.

The UK Jurisdiction Taskforce's Legal Statement on the Status of Cryptoassets and Smart Contracts (the "Legal Statement") is proving to be influential both domestically and internationally for its analysis of the legal status of cryptoassets. The Legal Statement recognised that the design of cryptoassets may create some practical obstacles to legal intervention but "that does not mean that crypto assets are outside the law". This is now developing into a trend.

In the English court judgment of AA v Persons Unknown, the Court held that "a crypto asset…[is] property" for the purposes of being subject to an interim proprietary injunction. Internationally, the High Court of New Zealand has ruled in Ruscoe v Cryptopia Limited (in liquidation) CIV-2019-409-000544 [2020] NZHC 728, which referenced the Legal Statement and AA v Persons Unknown in determining that cryptocurrency was "property".

3. Smart Contracts

A smart contract is, to put it simply, a contract with the capability to monitor, execute and enforce its terms, which has been made possible by the technological advancements made regarding DLT.

Transaction of security tokens in funds can be completed using smart contracts, leading to obvious benefits; they can be more secure, transparent, quicker and less costly than traditional contracts. Accordingly, many have speculated that the automatic and immutable nature of smart contracts will mean that the potential for disputes arising will be removed altogether. However, on the contrary, it is likely that, as the application of smart contracts continues to grow, it will bring with it the potential for new and unforeseen disputes.

Is a smart contract legally binding?

Given the relative infancy of smart contracts, it is unsurprising that there is no binding authority regarding their legal status. In principle, the Legal Statement outlines that the ordinary rules of English contract law should apply to smart contracts, in that they can be treated as legally binding contracts provided that:

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[3] World Economic Forum: *5 reasons dispute resolution is critical for blockchain's growth* December 2020

1. the agreement has objectively been reached between the parties as to terms that are sufficiently certain;
2. the parties (objectively) intended to be legally bound by the agreement; and
3. unless the contract is made by deed, that each party to it has given consideration to one another, in order to make the contract enforceable.

Whilst this provides welcome clarity for English law, other civil law jurisdictions have different legal requirements for a legally binding contract to be formed. Given the inherent cross-jurisdictional nature of tokenised funds, well drafted clauses regarding the jurisdiction and governing law of the contracts will therefore be essential.

Potential areas for dispute

Coding errors or bugs within the code may open the possibility of unexpected issues regarding the performance of the contract, which may lead to disputes arising. It is also feasible that smart contracts may automatically and wrongly perform because of an error in the data being provided by the fund[4].

Further, as the success of smart contracts hinge on their ability to express contractual terms in code, there will inevitably be challenges concerning the conversion of natural language[5]. Whilst lawyers will undoubtedly need to become more tech-savvy in order to implement these codes successfully, this raises the possibility of disputes occurring where there are differences between the natural language and coded versions of the contract.

Changes in law or regulation rendering the performance of the contract illegal could also lead to disputes given the immutable nature of DLT. Finally, as with any other contract, the court could also be asked to resolve disputes whereby parties wish to terminate or unwind the smart contract for a repudiatory breach, misrepresentation, mistake, fraud or duress.

4. Potential issues with jurisdiction

One of the key advantages of tokenisation of assets is the ability for the tokens, once issued, to be traded in the secondary markets. This potentially allows for access to a much wider base of investors, offering many benefits such as enabling more investment into start-ups and other businesses.

The nature of DLT means that secondary markets used for trading tokens would be global. Tokens may therefore be offered by an entity in one jurisdiction to an entity or multiple entities located in other jurisdictions. One potential pitfall of this cross-border relationship is that it may lead to uncertainty over which court or tribunal will have jurisdiction to hear any disputes.

The importance of having certainty of jurisdiction for dispute resolution should not be understated, as having assurance of what rights and remedies will be available to protect an asset also protects the value of that asset. Where a dispute is heard could have a considerable effect on the types of remedies available and costs of legal proceedings.

The most effective way to ensure certainty of jurisdiction is to include an exclusive jurisdiction clause or an arbitration agreement in the underlying contract, which limits disputes to the courts of only one jurisdiction or to arbitration.

5. Enforcement

If a party who obtains a successful judgment or award cannot enforce their rights or remedies, that judgment will not have any commercial value. In cross-border disputes, it will be important to ensure that any judgment or award obtained in one jurisdiction will be recognised and enforced by a court in the jurisdiction where the assets or the defendant is situated.

By nature, tokens can be easily transferred, and assets can be quickly dissipated. DLTs often use complex

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[4] Norton Rose Fulbright: *Arbitrating Smart Contract disputes* October 2017

[5] MIK, Eliza: *Smart contracts: Terminology, technical limitations and real world complexity* October 2017

structures which could also potentially make it difficult to track ownership of tokens, albeit the ability for tokens to provide a clear, transparent and definitive record of ownership should hopefully minimise this risk.

How quickly and efficiently a judgment or award can be enforced will vary from country to country, which could have a significant impact on the recovery of assets due to the transferability of tokens and the need for quick action. As such choosing a jurisdiction that is adaptive and can respond quickly to provide legal remedies will be important.

DLTs may also offer mechanisms for faster enforcement, e.g. certain action happening automatically on certain trigger events occurring. Alternatively, there could be mechanisms in the smart contract that allow, for example, a tribunal rights to implement certain actions on the blockchain to avoid the risk that the tribunal's decision gets avoided.

6. Blockchain and smart contract-based dispute resolution

The growth of emerging technologies has also led to innovative approaches to dispute resolution. The use of blockchain for dispute resolution is one of those areas. Examples of solutions which aim to provide a mechanism for resolving disputes flowing out of smart contracts include (the below examples are for illustrative purposes only and do not amount to recommendations of these solutions):

- **Kleros**: Kleros operates by crowdsourcing anonymous "jurors", who deposit tokens in order to be selected. Jurors will then review the available evidence and make a decision. Those jurors who render an award which is consistent with the view of the majority will receive a payment, thereby in theory incentivising them to arrive at the "right" decision. Jurors who decide against the majority are penalised through the loss of tokens, which are transferred to the jurors who voted correctly. However, the nature of Kleros, whereby jurors have a financial interest in voting the "right" way, arguably impedes impartiality (i.e. will jurors make their decision based on what they truly consider to be the right outcome, or on what they perceive to be the most likely majority outcome?). The anonymous nature and unknown expertise of the jurors also presents difficulties, and means it is likely only to be suitable in the context of day-to-day transactions, as opposed to large scale complex disputes.
- **Confideal**: Confideal is a service which offers smart contracts which contain an integrated arbitration mechanism, allowing users to resolve their disputes without having to engage any third-party intermediaries outside of the chain. Users select their preferred arbitrator at the time of entering into their smart contract, with arbitrators being drawn from "members of associations, arbitration centres or other organizations which confirm their status as professional arbitrators", thereby providing reassurance to users as to the appropriateness / expertise of their selected arbitrator. Confideal also includes rating system for arbitrators, so that in theory the best-ranked arbitrators should receive more instructions, thereby bolstering the quality of justice administered.
- **Juris Protocol**: Juris provides an alternative dispute resolution system for blockchain smart contracts, and users can opt to have code embedded into their contract. In the event of a dispute, the Juris Protocol is initiated and performance under the smart contract is frozen. There is then a staged process for resolution of the dispute involving self-mediation, a poll judgement and a binding panel judgement as a final step.
- **CodeLegit**: CodeLegit supplies smart contracts with its "Arbitration Library" incorporated into the code of those contracts. Once a party triggers the Arbitration Library, performance under the smart contract will be paused. CodeLegit will then appoint an arbitrator, who may be legally qualified or alternatively may be someone with technical expertise. The CodeLegit model envisages that most communications will be via email, however arbitrators can request a hearing (either in person or virtually), if they consider it to be appropriate. In this regard, CodeLegit is closer to traditional dispute resolution forums than some other models.
- **Digital Dispute Resolution Rules (DDRR)**: The UK Jurisdiction Taskforce (UKJT) has now published the UK's first Digital Dispute Resolution Rules (DDRR). The DDRR give legal effect to automatic dispute resolution processes built into digital asset systems. They also create a streamlined arbitral process for resolving disputes arising out of new digital technologies. The aim of the DDRR is to ensure the rapid, cost-effective resolution of disputes arising out of new

digital technologies (e.g. cryptoassets, cryptocurrencies, smart contracts, distributed ledger technologies and fintech applications). They create a dispute resolution process which is intended to be flexible enough to resolve "traditional" disputes relating to conventional written contracts, as well as "novel" disputes relating to the use of digital assets (including where the parties are unknown to one another and have transacted anonymously on a blockchain). The DDRR can be incorporated into any relevant contract, digital asset or digital asset system using, at a minimum, the following text: "*Any dispute shall be resolved in accordance with the UKJT Digital Dispute Resolution Rules*" (the incorporation text). This text can be in electronic or encoded form.

Whilst the benefits of having dedicated, fast, in-built mechanisms for the resolution of disputes arising out of smart contracts are clear, it does also present challenges:

- The solutions available will typically be limited - either financial or a change to performance under the smart contract. There is also no ability under these mechanisms to seek solutions like search orders or stopping money leaving a bank account.
- Decisions will typically be decided upon limited, documentary information without the opportunity for cross-examination of witnesses or oral submissions.
- Depending on the model, jurors may be lacking in expertise, and their decisions may be influenced by financial incentives.
- Lack of transparency over decision making can affect the perception of justice and the overall satisfaction of a party that it had its issues heard. This can lead to a growing sense of injustice and pent-up grievance.
- Opportunities for appeal may be inconsistent and potentially unattractive.
- The extent to which decisions of such bodies will be upheld and enforced by local courts is uncertain and will depend on the nature of the model and the relevant jurisdiction.

7. Liability for tokenised funds

The liability issues that arise in the context of funds are likely to also apply to tokenised funds. For example:

1. Claims for mis-selling or misrepresentation
2. Sections 90 and 90A of the Financial Services and Markets Act 2000 ("FSMA")
3. Breach of the FSMA 2000 (Financial Promotion) Order 2005 ("FPO")

Misrepresentation and mis-selling

Where products or investments reveal themselves to have been sold on an incorrect or misleading basis the issuer or any intermediary involved in giving advice could be liable for claims by the investors for misrepresentation/mis-selling. The extent and scope of this liability will be dependent on the terms and conditions of the sale/investment and what statements were made in relation to the tokenised funds.

Sections 90 and 90A of FSMA

Where a tokenised fund is listed, sections 90 and 90A of FSMA provide shareholders with a direct cause of action for misleading/untrue statements made in prospectuses or listing particulars (for section 90) and certain other information published by the company (section 90A). Claims may be brought against a public company and/or (in the case of section 90 only) its directors or those stated as accepting responsibility for the prospectus or listing particulars.

The extent of the risk under the section 90 FSMA regime will depend on the company and its sector, as the overriding disclosure obligation for a prospectus or listing particulars focuses on the inclusion of information that is material to an investor.

Section 90A FSMA claims may arise in the context of documents published via a recognised information service.

Claims under section 90 and 90A of FSMA are not straightforward. For example, it is a defence to a claim under section 90 to show that that there was a reasonable belief that the statement complained of was true and not misleading or that the omission was justifiable in the circumstances. In relation to section 90A claims, a key requirement for establishing liability is knowledge. The issuer is liable where there is an

untrue or misleading statement and a person discharging managerial responsibilities (PDMR) within the issuer knew the statement to be untrue or misleading or was reckless as to that fact.

In order to establish liability under section 90 there is no requirement for reliance on the untrue/misleading information. However, section 90A liability does require the person bringing the claim to show reliance on the untrue/misleading statement and that it was reasonable for that person to rely on the statement being complained of at the time and in the circumstances applicable.

In respect of omissions and delay in publication of information, liability arises where the PDMR knew the omission was a dishonest concealment of a material fact or acted dishonestly in delaying publication of information.

For further details of the dynamics of these claims, please see CMS' LawNow bulletin here.

FPO

In summary, a "financial promotion" is any invitation or inducement to engage in an investment activity. Any form of marketing that seeks to solicit investors to acquire certain investments, is likely to be a financial promotion. This includes, for example, the communications made in relation to units in collective investment schemes, and accordingly, tokenised funds.

Section 21 of FSMA places a general prohibition on the communication of financial promotions in the course of business unless the financial promotion:

- is issued by an FCA-authorised person;
- is approved by an FCA-authorised person; or
- falls within an exemption from the financial promotion regime.

Should there be a breach of the financial promotion regime, then the penalties are as follows:

- Unenforceability: An agreement made by a person in contravention of the financial promotion regime is unenforceable against the other party. As such, this will enable investors to recover any money or property paid and/or compensation for any loss sustained as a result of having parted with monies.
- Criminal sanctions: A person who contravenes the financial promotion regime is guilty of an offence and liable: on summary conviction, to imprisonment for a term not exceeding six months or a fine not exceeding the statutory maximum, or both, and on conviction on indictment, to imprisonment for a term not exceeding two years or a fine, or both.

8. Conclusion

The liability issues that arise in the context of funds are likely to also apply to tokenised funds. This will include resolving issues such as legal status and characterisation of tokenised funds, the binding nature of smart contracts used in the context of tokenised funds, how those contracts are interpreted when compared with traditional contracts, ensuring there is clarity on the legal regime/jurisdiction that applies to the tokenised funds and routes to enforcement.

Finally, having an accepted and respected method of dispute resolution is a key component to the growth of tokenised funds. Without this, it is likely that many funds will not function as well as those where dispute resolution is available, which will ultimately reduce its utility.

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