

Fund Finance Friday

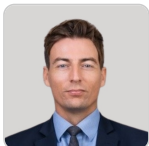


Fund Finance x Crypto – Tokenized Investment Funds

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By **Alexandra Woodcock**
Partner | Mourant Ozannes (Cayman) LLP



By **Finn Howie**
Partner | Mourant Ozannes (Cayman) LLP



By **Ramesh Maharaj**
Partner | Mourant Ozannes (Cayman) LLP



By **Sara Galletly**
Partner | Mourant Ozannes (Cayman) LLP



By **Alastair Lagrange**
Counsel | Mourant Ozannes (Cayman) LLP

With the growth of fund finance we have all observed cross-over between areas such as securitization, structured finance, and the insurance sector, blurring the lines between historically separate areas. The next frontier is rapidly coming into focus: crypto. In the Cayman Islands, which is somewhat of a 'sandbox' for virtual asset experimentation and innovation, we are already thinking about virtual assets in the fund finance context.

In the first instalment of our *Fund Finance x Crypto* series, we discussed security over custodied digital assets from a Cayman Islands law perspective. In the second instalment of this series, we will examine the advent of tokenized investment funds.

Part Two - Tokenized investment funds.

The Virtual Asset Service Providers (VASP) Act, which regulates digital service providers in the Cayman Islands, was amended in 2025 to ensure that tokenized funds are not required to register under that legislation. The Cayman Islands Government is currently consulting with industry on further legislative revisions intended to provide further clarity on the position regarding tokenized investment funds. Broadly, a tokenized fund issues its interests as digital tokens on a distributed ledger whether in addition to, or in place of, traditional interests. The fund's investments need not be digital assets but may be traditional fund assets such as real estate, credit assets or private equity investments. There are already several funds offering such products, but the exact form and approach taken is important. The potential benefits include fractional ownership, broader accessibility and ultimately, increasing liquidity by creating a secondary market for tokens to be exchanged on regulated digital asset exchanges or peer-to-peer markets. The unique nature of subscription lending, being 'upward' looking to investor capital commitments, instead of 'downward' looking to fund assets, means that tokenization poses several challenges. Secondary markets for investors do not

combine that well with subscription facilities. While a subscription facility is in place, investor transfers are typically subject to lender consent, subject perhaps to a small basket allowing for transfers up to an agreed threshold. A lender would likely require that full recourse to the original investor is maintained, even if that investor participates its interest on the secondary market in order to obtain liquidity.

A lender exploring financing a tokenized fund must analyse how the tokenized fund is structured to understand exactly how investors are treated, admitted and obligated to fund capital calls. Again, a conceptual exercise is involved. A 'tokenized fund' can mean different things, the primary ones for our purposes being:

1. The token itself is the investor's legal interest in the fund (**Native Token Model**).
2. The token is simply a digital representation of the traditional interest issued by the fund, such as partnership interests which are still recorded on a traditional partnership register maintained by the fund's administrator (**Digital Receipt Model**).

The holy grail of tokenized funds is the full Native Token Model which allows interests recorded only on the distributed ledger, rather than traditional statutory registers. A subscription lender performing its underwriting analysis on a borrower is focused on, more so than perhaps any other area of finance, the legal relationship between the fund entity and its investors. It is that bundle of contractual rights, rather than hard assets, tradable securities or cashflows generated by an operating business, which underwrites the credit risk. The area of focus is the right to call uncalled commitments from the investor if the fund defaults on the facility. The lender must diligence exactly how a token-holder would be obligated to fund capital calls and how remedies can be pursued against a defaulting token-holder via the distributed ledger. The good news is that problem solving around investor recourse is nothing new to fund finance lawyers. Many funds have investors with sovereign immunity or located in difficult to enforce jurisdictions. Such weaknesses in the borrowing base are addressed by protections in the credit facility such as restricted advance rates, mandatory prepayment triggers, investor waiver/consent letters or other contractual protections.

In a typical capital call security package, the lender will hold a power of attorney allowing the lender to have third party rights to the GP's contractual remedies under the fund documentation. Could a power of attorney be embedded in a smart contract? In the Cayman Islands, to ensure a security power of attorney is irrevocable and survives the bankruptcy of the grantor, a power of attorney must meet the requirements of the Powers of Attorney Act (as revised). This statute dates from 1996 so could usefully be updated for the age of smart contracts. The smart contract concept is highly attractive in a subscription lending context for several reasons. First, it reduces the time taken to enforce, which should theoretically lead to a lower probability of loss given default. Secondly, it would theoretically lower the upfront cost and complexity of implementing a traditional security package. One example of this is that under Cayman Islands law, an investor notice must be delivered to investors in order to achieve a first ranking position under the long-established priority rule in the case of *Dearle v Hall (1828)*. If an investor can simply be notified via smart contract on the blockchain, that would remove the requirement for an analogue form of investment notice delivered mechanically to investors. There is no prescribed form of notice required by Cayman Islands law, so provided the fundamentals are covered in the smart contract, notification via blockchain and satisfaction of the above priority rule is theoretically possible.^[1] Finally, there is arguably (although this can be debated) a greater degree of protection against fraudulent or wilful breach of a negative pledge provision. All transactions on the blockchain are verifiable and service providers with expertise in tracing blockchain transactions exist in the market.

The above concept remains a distant way off for various reasons. However, in our view the Digital Receipt Model described above should already be bankable and the analysis would be largely the same as with any subscription credit facility executed in today's market, with the tokenized aspect largely unheeded for security perfection purposes.

In the next instalment of this series, we will look at the latest **Luxembourg developments** in this area.

^[1] Albeit in a litigation context, English courts have already held that service via distributed ledger is an effective means of service. See *Tai Mo Shan Ltd v. Persons Unknown* [2024] EWHC (Comm) 1514.