Tokenised investment funds in the Cayman Islands: new benefits and old rules

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Introduction

Some time ago, the tokenisation of assets moved beyond the experimental stage in the context of investment funds in the Cayman Islands. What perhaps began as a niche exercise in representing interests on a blockchain is increasingly being proposed by mainstream sponsors as a way to broaden distribution, reduce administrative friction and, in theory at least, to improve secondary market liquidity.

The Cayman Islands has already taken a pragmatic step by clarifying that properly structured tokenised fund interests do not, of themselves, trigger regulation under the Virtual Asset Service Provider (VASP) regime, which had previously been a grey area that resulted in an understandably cautious approach. Please see our previous updates on this development here and here.

This removes one very important layer of uncertainty (albeit at the time of writing this Article, more changes are proposed). It does not, however, answer an arguably more important question: how does tokenisation interact with the traditional principles of fund governance and fund finance?

Tokenisation – use cases

A tokenised fund is simply an investment fund whose interests (whether participating shares or limited partnership interests) are issued, recorded or represented using distributed ledger technology. The investment objective and investment strategy of the fund need not have any other connection with financial technology or blockchain. Interests in investment funds whose strategy focuses on more traditional assets classes such as real estate, private credit, private equity/venture capital and infrastructure projects are all being issued in tokenised form.

The difficulty with tokenisation from a governance perspective is that most of the legal risks in investment fund structures do not sit with the assets in which the fund invests. It instead sits with the relationship between the investment fund, the investment manager and the investors in the fund, and in the myriad of rights, obligations, discretions, constraints and disclosures that are set out in the offering documents (which are underpinned by the constitutional documents of the investment fund).

Despite its other advantages, tokenisation does not make those issues go away. It does, however, require those issues to be expressed and dealt with in a different way depending on the type of tokenisation adopted. Two models of tokenisation tend to dominate; the 'digital receipt model' and the 'native token model'.

Digital receipt model vs. native token model – governance implications

In the 'digital receipt' model, the token is a digital representation of a traditional interest in an investment fund; e.g. a tokenised participating share or a tokenised limited partnership interest. The legal record and 'one source of truth' remains (as with non-tokenised funds) the register of members or register of limited partners that are maintained typically by the fund's administrator.

In the "native token" model, the token itself is intended to be the legal interest, with the definitive record of ownership sitting on the blockchain ledger rather than in an administrator's database. From a fund governance perspective, these two models are materially different.

Under the digital receipt model, very little changes either in substance or in practice. Any transfers of participating shares would, to the extent permitted, still need to comply with the transfer provisions in the constitutional documents of the fund. Consents would still be required as they would be with a non-tokenised fund whilst any side letters providing bespoke terms to individual investors would operate in the same way. The general partner or board of the fund are still required to exercise the same discretions and they remain subject to the same fiduciary duties and contractual constraints. The tokenisation of the interests in the fund is, in legal terms, largely cosmetic and whilst it may improve the user experience, it does not displace the existing framework.

The native token model poses material challenges for this traditional approach, and it is perhaps for this reason that, to date, the digital receipts model is the preferred approach as whilst it embraces blockchain technology, it still feels familiar. However, where the token is the interest, then the rules governing admission, transfers, suspensions, side letters, redemptions (if any) and the enforcement of obligations must, to some degree, be reflected in the token architecture or the smart contracts that underpin it. The difficulty with this is that many issues that were previously ambiguous or subject to the exercise of discretion must now be treated in a binary way. For example, most fund documents are deliberately drafted with a degree of flexibility and in many cases ambiguity so as to give the general partner or board a degree of discretion. They allow managers to respond to tricky, real-world situations that can't always be anticipated.

By way of example, the terms of a limited partnership agreement of a typical closed-ended private investment fund in the Cayman Islands will typically prohibit transfer of partnership interests without first obtaining the consent of the general partner, and that consent will almost always be exercisable in the general partner's discretion. What isn't clear is how that discretion will be implemented on-chain. If the token is freely transferable by design, a core governance control has been surrendered. If transfers are technically blocked unless a permission is toggled, then the system is, in substance, still centralised; just with a more elaborate wrapper.

The same issue arises when one considers that Cayman Islands investment funds are required to undertake anti-money laundering and 'know your client' checks on all investors. How can this be done effectively if fund interests are freely transferable on-chain in real time?

Similar issues arise in relation to defaults and the exercise of contractual remedies against investors. Again, these are rarely binary or mechanical decisions. They are governed by layered contractual

provisions and, in practice, by judgement calls and a risk-based approach. Encoding that entire framework into smart contracts is not simply a technical exercise; it is a governance choice about which decisions are automated and which remain discretionary.

Fund finance – tokenisation issues

These issues become even sharper in the context of fund financing, and in particular subscription facilities. Subscription finance is, by design, “upward-looking”; the lender’s credit analysis is focused less on the fund’s assets and more on the legal enforceability of the investors’ capital commitments and the fund’s ability to call and collect them when they become due to secure the servicing of interest payments and repayment of principal.

From a lender’s perspective, the essential question is not whether interests are represented by certificates, entries on a fund’s register or tokens on a ledger. The question is whether the lender can obtain reliable security over the fund’s rights against its investors and whether, in a default scenario, those rights can be exercised quickly and predictably.

Under the digital receipt model, the analysis is largely conventional since, as noted above, the token does not displace the traditional legal infrastructure. The register remains the definitive record of investors. Capital call mechanics remain as set out in the offering documents. Security is taken over the usual rights of the fund (i.e. the right to call capital, the right to receive contributions and the right to enforce remedies against investors who default). From a security perfection and enforcement perspective, the “tokenised” aspect is, to an extent, irrelevant. It may affect how information is presented to investors and how they view their investment, but it does not change what the lender is really relying on.

The native token model is more challenging. If the token is the legal interest, the lender must understand, in detail, how that token carries with it the obligation to fund capital calls and how and when that obligation can be enforced. Immediate issues to consider would be:

Would the smart contract operate to automatically block transfers upon the occurrence of a default?

Can the smart contract automatically redirect distributions?

Does enforcement of these rights still require traditional steps, such as serving statutory demands and the exercise of contractual discretions by the general partner or board? If so, the lender is back in the familiar world of legal process but with an additional technical layer to navigate.

We would also note that there is a natural tension between secondary market liquidity and subscription finance. Subscription facilities typically restrict investor transfers without lender consent, often subject only to narrow baskets and defaulting investors would be prohibited from transferring. The commercially sensible reason for this is the lender underwrites subscription facilities based on a defined and screened pool of investors that have undergone the full credit underwriting process. A freely transferable token cuts directly across that model. In practice, a lender would be likely to insist either on tight transfer controls being written into the token mechanics or the underlying smart contract or on full recourse being preserved against the original investor, regardless of any secondary participation.

Conclusion

In practice, the more conservative digital receipt model fits far more comfortably with both existing governance frameworks and current fund finance structures. The administrator still controls the register. The general partner or board still controls admissions and transfers and the onboarding process thus ensuring AML/KYC compliance. The lender still takes security over recognisable contractual rights. The token becomes a distribution and record-keeping tool, not the legal source of truth. It embraces emerging financial technology which is appealing to many but it remains comfortably familiar.

The native token model may yet mature into something that lenders are willing to underwrite on its own terms. But that will require more than legislative tidying-up or more sophisticated smart contracts. It will require a re-engineering of fund documentation and credit structures so that discretion, enforcement and dispute resolution are coherently integrated with on-chain mechanics. The form that investments take may be evolving into a new form, but the commercial and credit risk, and the law that manages them, are not.

This publication is not intended to be a substitute for specific legal advice or a legal opinion. For specific legal advice on the subject matter of this Briefing, please contact:

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