

Digital asset private funds: a primer for investors and fund sponsors

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While digital asset funds are rising in popularity, the level of expertise surrounding the asset class continues to lag. According to survey results released last year, 81% of institutional investors expected an increase in digital asset allocation over the next two to five years, while only 10% or fewer claimed to have expert-level knowledge of various digital asset concepts¹.

Investors exploring opportunities to invest in a digital asset fund should be cognizant of the unique considerations in dealing with digital assets in a private fund, including concerns regarding complexity, liquidity, valuation, transparency and regulatory changes.

Types of digital asset funds

Digital asset funds are private market funds that allocate some portion of their investments to cryptocurrencies and other crypto assets.

There are two types of commonly formed digital asset funds:

- **Core focus.** Funds that are fully or mostly dedicated to digital asset investments. Investments are executed directly in digital assets or by engaging in digital asset-adjacent transactions, where a more standard form of asset is the primary subject of the transaction, with a smaller digital asset component tangentially attached. Funds may also pursue a combination of the two.
- **Ancillary focus.** Funds that dedicate a small bucket (often 10% to 15%) of their aggregate capital commitments to digital asset transactions but maintain their primary investment objective outside of digital assets. These funds may also provide for an additional small bucket (often 2%) framed as a “token pool” for foothold or seed investing.

Key considerations

Fund sponsors and investors need to manage several unique considerations when dealing with digital asset funds.

Distributions-in-kind

Distributions-in-kind raise two major questions:

- whether the fund can receive digital assets from portfolio companies as a distribution-in-kind; and
- whether investors can receive digital assets from funds as a distribution-in-kind.

These questions can be answered by looking at three factors.

Definition of “marketable securities” and “securities”

In a fund’s limited partnership agreement, the definition of “distributable proceeds” may include fairly vague language. One example might be “cash and other property to be received by the fund and to be made available for distribution to investors”—which, without any other verbiage restricting investments in digital assets, could mean that the fund could distribute digital assets in-kind to its investors. The definition of “securities” or “marketable securities” (or related defined terms) could also capture concepts that explicitly or implicitly include digital assets, such that under such definitions, digital assets could be distributed in-kind to investors.

External and internal limitations by LPs

Institutional investors may be subject to limitations pursuant to applicable law or internal policy that restrict their ability to receive distributions in-kind in the form of digital assets specifically or non-marketable securities more generally.

Those limitations may eliminate certain funds as an option for direct investment. Alternatively, the investment could be structured in a manner that satisfies the investors’ investment limitations but provides the desired exposure to digital assets. If all else fails, investors could look to negotiate an excuse right—which would excuse them from contributing any capital to such digital asset investments (or in lieu of an excuse right, a transfer right).

In addition, institutional investors who intend to commit large amounts of capital to a fund may be interested in appointing a third-party custodian to safeguard and manage the in-kind digital assets distributed to them by the fund. In the context of a digital asset fund, such investors should be mindful that certain custodians may be unable or unwilling to take custody of digital assets distributed in-kind.

Momentary distributions-in-kind

Transactions in the digital ecosystem may require a momentary distribution in-kind as a step towards executing the transaction (e.g., a GP-led secondary where the general partner makes a momentary distribution in-kind of the continuation fund’s interests to facilitate a redemption for a liquidity investor). Investors should determine whether such momentary distributions in-kind would violate any of their statutory or policy restrictions.

Recycling

Funds typically provide for a limit on recycling (if any). Given the nature of digital assets transactions, which often involve frequent movement in and out of digital assets, funds may modify the more typical recycling language to exclude from the recycling provision:

- proceeds from the disposition of digital assets; and
- proceeds deployed in digital assets.

Investors should be mindful of broad recycling carve-outs in digital asset funds and should consider working with the fund sponsor to tailor the recycling provision to limit the recycling carve-outs in respect of digital assets to circumstances required by the fund (e.g., moving in and out of crypto assets to facilitate a transaction).

Indemnification and exculpation

Given the constantly evolving regulatory landscape in the digital asset space, there is a frequent debate between fund sponsors and investors about whether a material breach of applicable securities law should be excluded from the indemnification and exculpation coverage under the fund’s limited partnership agreement in a digital asset fund.

- **Fund sponsor argument.** Fund sponsors may argue that digital asset funds typically do not make this exclusion from the indemnification and exculpation coverage. They may also argue that investors should be well aware of the lack of defined guidance and the constantly evolving nature of the digital asset space when deciding to invest in a digital asset fund.
- **Investor argument.** Investors may argue that GPs should be expected to be fully apprised of the regulatory landscape in which they operate. In addition, in respect of any ambiguity in the law, investors may argue that fund sponsors should be able to take the position that their actions do not constitute a material violation.

Potential compromises to the above debate include: (i) limiting the investments of the digital asset fund to a list of prescribed digital assets that are not considered to be securities; (ii) excluding any *ex post facto* violations from indemnification and exculpation carve-outs; and (iii) providing that the carve-outs will be automatically modified as necessary upon passage of applicable regulations or laws.

Valuation

In respect of closed-ended funds, valuation is preferably determined with reference to a specific market or exchange (e.g., Binance, Coinbase, Kraken, Crypto.com), as well as a backup if the primary exchange becomes defunct. Most often, the valuation policy is broad and allows the manager to value digital assets much like it would other types of privately held securities.

In respect of open-ended funds, valuation is particularly important given the volatility of digital assets together with the fact that investors typically have redemption rights. Fund sponsors and investors alike may wish to give particular thought to the redemption request process; investors may try to seek upper/lower valuation bands and the ability to withdraw or defer their redemption requests in light of any material variations in valuation (which would otherwise generally be atypical in a non-digital asset fund). Fund sponsors should also be mindful of any applicable bonding and unbonding periods (similar to lockup periods for securities) associated with certain digital assets when structuring redemption rights.

FOOTNOTES

1. https://www.oxfordeconomics.com/wp-content/uploads/2023/01/State-Street-Digital-Assets-Survey-Presentation-021522.pdf?utm_source=Recent-release&utm_medium=Website&utm_campaign=TL-State-Street

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