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Deloitte Cayman Islands Technical Brief for Investment Funds

Accounting, Auditing and Regulatory

January 2025

In this issue

Introduction

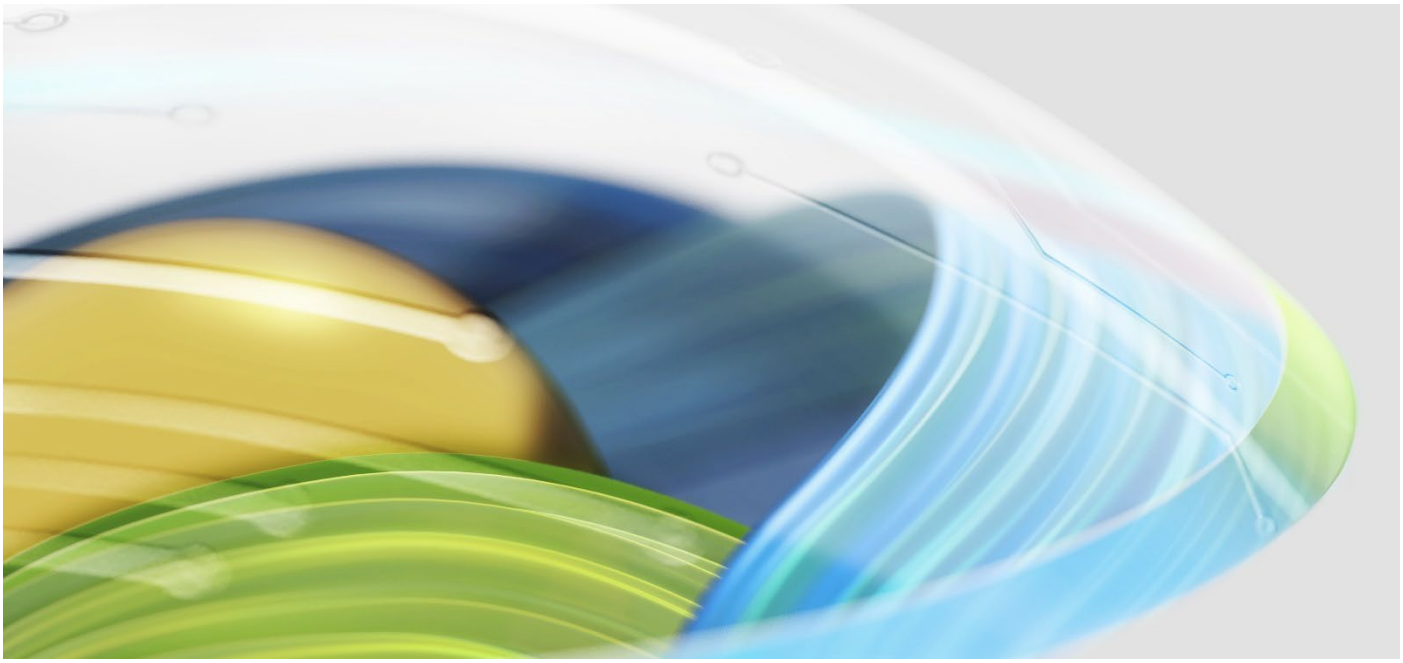
The Technical Brief for Investment Funds ("Tech Brief") is an annual newsletter developed by the Deloitte Cayman Islands Investment Funds Technical Team.

The Cayman Islands continues to be a jurisdiction with a significant number of registered investment funds. At the beginning of September 2024, there were approximately 13,000 Mutual Funds (open-ended funds) registered in the Cayman Islands and approximately 17,000 registered Private Funds (closed-ended funds). The approximate 30,000 total registered funds compares to around 29,500 at the end of 2023. Also, since 2020, when the Cayman Islands introduced a virtual asset service provider framework, there has been an increase in the number of registration applications for business and services in the digital assets industry of the Cayman Islands.

From an accounting and financial reporting standpoint, over the past year, there have not been any significant updates to United States and International Accounting Standards that will affect investment managers and/or investment funds. In this Tech Brief, we have summarized some upcoming accounting and financial reporting standards that investment funds and their managers may have to contend with. This content has also been covered in previous Tech Briefs.

On the regulatory front, there have been a few new developments that may directly or indirectly affect the investment funds industry. We have included a summary of select regulatory matters and some updates to Cayman Islands regulations and acts discussed in previous Tech Briefs.

Finally, as in previous Tech Briefs, we have included a brief overview of the voluntary liquidation process for Cayman Islands investment funds. Included in this overview is a discussion of specific circumstances where a registered liquidating Mutual Fund or Private Fund may be granted an exemption by the Cayman Islands Monetary Authority ("CIMA") from a final liquidation audit if a third-party liquidator has been appointed, and such liquidator undertakes certain prescribed procedures. We have also outlined some factors motivating managers and those charged with governance to explore voluntary liquidations. Further, the final liquidation audit exemption might be of interest to operators of funds that would not otherwise require a final liquidation audit for other purposes (such as, for example, satisfying the final liquidation audit requirements of the Securities and Exchange Commission Custody Rule).



US GAAP Update

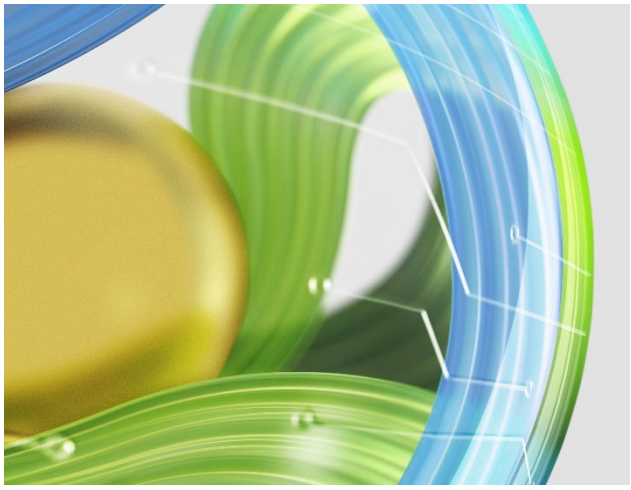
Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions (ASU 2022-03)

Introduction

ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions, clarifies certain requirements of Topic 820, Fair Value Measurement, regarding measuring fair value of equity securities subject to contractual sale restrictions. Further, ASU 2022-03 requires new disclosures for such equity securities. The amendments affect all entities that hold equity securities measured at fair value per Topic 820 and that have contractual sale restrictions. As such, this ASU could potentially impact investment funds that invest in such securities.

Status

ASU 2022-03 was effective for public business entities with interim periods and fiscal years beginning after December 15, 2023. For other entities, the amendments are effective for interim periods and fiscal years beginning after December 15, 2024. Earlier adoption was permitted. A reporting entity, other than investment companies per Topic 946, Financial Services – Investment Companies, will need to apply the requirements of ASU 2022-03 prospectively. Investment companies within the scope of Topic 946 will need to apply the requirements of ASU 2022-03 to equity securities for which the contractual sale restriction is executed or modified on or after the date of adoption. Any equity securities for which the contractual sale restriction was executed before the date of adoption will be accounted for using the accounting guidance in effect before such date. However, when the restriction is modified or expired, the guidance per ASU 2022-03 will be applied.



Summary

ASU 2022-03 clarifies scenarios when a contractual sale restriction is and is not considered as being part of the unit of account of an equity security and as such, when the restriction should or should not be considered in measuring the fair value of the related security. Under ASU 2022-03, a "contractual sale restriction prohibiting the sale of an equity security is a characteristic of the reporting entity holding the equity security" and is not included in the equity security's unit of account. A reporting entity would therefore not consider the contractual sale restriction in the determination of its fair value and would thus not consider the application of a discount related to the restriction.

Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions (ASU 2022-03) (continued)

Summary (continued)

A summary of the valuation provisions:

- A reporting entity should consider sale restrictions that are characteristics of the equity security itself. For example, a restriction resulting from a security that is not registered for sale with a national securities exchange or an over-the-counter market, when other securities from the same class of stock are registered for sale.
- A reporting entity should not consider sales restrictions that are characteristics of the holder of the security. For example, lock-up agreements, a market stand-off agreement, or a sale restriction provision within an agreement between shareholders or other parties.

As previously mentioned, ASU 2022-03 also introduces new disclosure requirements, which include, disclosing the fair value of equity securities in scope of ASU 2022-03, the nature and duration of any sale restrictions on equity securities and any circumstances that could result in a lapse of the restrictions.

It is important to note that ASU 2022-03 does not change how fair value is measured in accordance with Topic 820, but rather clarifies certain principles set out in Topic 820, in addition to requiring new disclosures.

Regulatory and Legal Update

Environmental, Social, and Governance ("ESG") Investment Practices

In recent years, investment management companies have seen increased pressure to incorporate ESG factors into their day-to-day operations and many consider the incorporation of such factors as a pre-requisite for long-term success based upon the needs of their investors, their investment strategies, and their regulators.

On March 6, 2024, the Securities and Exchange Commission ("SEC") adopted regulations requiring SEC registrants to disclose climate-related information in their registration statements and certain reports, such as Form 10-K. Examples of required disclosures, whether within the financial statements or other reports, include, but are not limited to, financial impacts of severe weather events in their audited financial statements, governance of climate-related risks, including management's role in assessing these risks and oversight by the board of directors, if any is performed, material impacts of actual and potential climate-related risks on their business strategy, results of operations and financial condition, etc. These rules are to be adopted prospectively and are effective as early as the year ending on December 31, 2025. Some rules are effective in later years depending on the nature of the required disclosure. These new rules require additional information to be disclosed, which could impact registrants' internal processes and controls. As such, investment management companies registered with the SEC should be aware of this new framework and are encouraged to start preparing, where applicable.

Similarly, other regulators have developed frameworks in relation to ESG, such as the European Union's Corporate Sustainability Reporting Directive and the International Sustainability Standards Board created by the IFRS Foundation. Some reporting requirements adopted by both of these regulators began on January 1, 2024. Further, CIMA has previously announced the need for standard setting in relation to ESG. In February 2024, CIMA launched a climate change and environmental-related risks survey to gather information on how CIMA regulated entities, including funds, manage climate-related risks, prior to establishing a related regulatory framework.

Many audit firms, including Deloitte, have developed policies and procedures to undertake verification activities, whether ESG-related disclosures in financial statements or stand-alone assurance engagements related to ESG. The annual global learning curriculum of Deloitte includes awareness and updates of ESG-related matters, as this will continue to be an area of interest for companies and regulators in upcoming years.

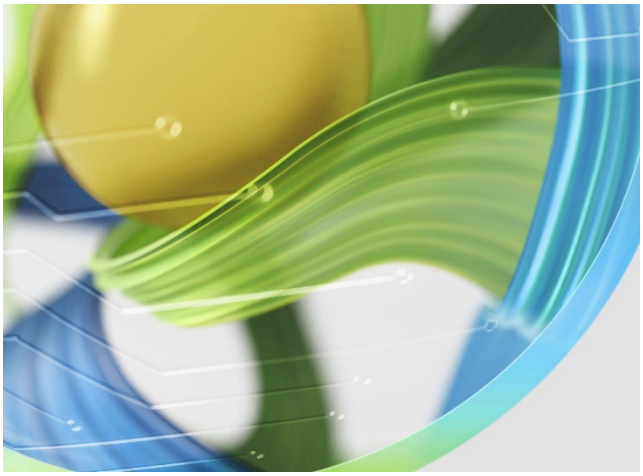
SEC's Enhanced Regulations of Private Fund Advisers

On August 23, 2023, the SEC adopted new rules and amendments that would have impacted private fund advisers. The SEC has stated that these enhanced regulations were meant to protect private funds and their investors. Some of the new rules and amendments were to be effective 60 days and 12 months from the publication date in August 2023. However, some, that could require significant effort to implement, were to be effective up to 18 months from the publication date. As an example, private fund advisers registered with the SEC would have needed to distribute quarterly statements to investors to disclose certain information such as fund fees paid by and allocated to the fund, expenses, and performance information. Also, private fund advisers registered with the SEC would have been required to distribute fund annual audited financial statements to investors. These were to be effective as of March 14, 2025.

On June 5, 2024, the U.S. Court of Appeals for the Fifth Circuit abolished the new rules and amendments adopted by the SEC, which were expected to have significant impacts on requirements for private fund advisers. Although these rules are no longer in effect and private fund advisers are not obliged to comply with the rules, they indicate what the SEC's views are on certain topics, which private fund advisers can consider in their management. In line with the latter, in October 2024, the SEC's Division of Examinations released their 2025 examination priorities, which are areas that present the highest risks, per the SEC's Division of Examinations. The release of these priorities is to increase transparency in the examination process. Private fund advisers are encouraged to familiarize themselves with the details of this publication. Examples of specific topics of interest to private fund advisers include whether disclosures, such as investment strategies, are in line with actual business practices in terms of market volatility and interest rate changes and whether the calculations and allocations of private fund fees and expenses are accurate.

Anti-Money Laundering

Since February 2021, the Cayman Islands has taken steps towards improving its anti-money laundering and combatting the financing of terrorism regime ("AML/CFT"), including by applying sanctions and taking administrative penalties and enforcement actions against obliged entities to ensure that AML/CFT breaches are remediated. On April 19, 2024, the Anti-Money Laundering (Amendment) Regulations, 2024 became effective. They include several amendments to the AML/CFT regulations such as clarification that the compliance requirements also apply to proliferation financing, the minimum for one-off transactions was reduced to CI $10,000 in instances where CI $15,000 was still included and certain requirements on risk assessment were reworded. The above are examples of amendments and not a comprehensive list of all amendments.



Operators of investment funds should remind their service providers of the requirements of the regulations, as well as of potential sanctions for non-compliance. This continues to be an area of focus by the Cayman Islands. At the beginning of 2024, the United Kingdom and the European Union removed the Cayman Islands from its list of countries which had AML/CFT deficiencies. It was noted that the Cayman Islands are largely compliant with the Financial Action Task Force's ("FATF") recommendations communicated when the Cayman Islands was included on the FATF's grey list in 2021 and subsequently removed in the last quarter of 2023.

Transparency Act and Beneficial Ownership Regime

In an effort to further align itself with the FATF's standards concerning AML/CFT, the Beneficial Ownership Transparency Act 2023 ("Transparency Act") and the Beneficial Ownership Transparency Regulations, 2024 ("Regulations") became effective on July 31, 2024. The Cayman Islands Ministry of Financial Services and Commerce ("Ministry") also published guidance on compliance with beneficial ownership obligations ("Guidance"). The Transparency Act, the Regulations, and the Guidance form part of the new beneficial ownership regime of the Cayman Islands ("New BO Regime"). The New BO Regime includes some changes to the prior beneficial ownership rules of particular importance to investment managers and investments funds. Investment funds registered under the Mutual Funds Act or the Private Funds Act are included in the definition of a legal person and are now in scope of the New BO Regime. Such funds will need to identify a beneficial ownership principal point of contact to respond to beneficial ownership requests from relevant particulars, instead of filing a beneficial ownership register. This point of contact can be a fund administrator, or a regulated person located in the Cayman Islands. Another relevant change is that a beneficial owner must be identified using a 25% or more threshold of beneficial ownership, rather than the 10% under prior rules.

The Ministry has indicated that the requirements of the New BO Regime will not be enforced until January 1, 2025. Entities are encouraged to implement changes to ensure compliance with the new requirements.

Virtual Asset (Service Providers) Act ("VASP Act")

In May 2020, the Cayman Islands introduced a framework for regulating virtual assets service providers ("VASPs"). In May 2024, CIMA published a regulatory policy detailing criteria to approve registration or licensing to VASPs. This regulatory policy applies to persons looking to register with CIMA to provide virtual asset services in or from the Cayman Islands and those seeking to obtain a license from CIMA to operate a trading platform or provide custodial services relating to virtual assets. Examples of factors relevant to approval, as defined in the regulatory policy, are fit and proper criteria, ownership and control, corporate governance, business plan, risk management, internal operational systems, and controls. Further, applicants are encouraged to discuss their application with CIMA prior to submission, to obtain a formal written legal opinion on their compliance with the requirements and to pay the application fee. Cayman entities operating in breach of the VASP Act will be imposed significant fines from CIMA. The licensing portion of the regulatory policy is not yet effective, although is expected to be when the Virtual Asset (Service Providers) (Amendment) Act, published in the last quarter of 2024, will be brought into force imminently. This amendment also introduces other requirements, such as, for example, the requirement for VASPs to have three directors, one of which is an independent director.

Targeted Sanctions - Russia

Since 2022, Cayman Islands financial service providers ("FSPs") and VASPs have been subject to legal obligations regarding the United Kingdom imposed sanctions. A legislative amendment to the sanction regime came into effect on March 14, 2024. This amendment allows Cayman Islands authorities to issue licenses to allow FSPs and VASPs to execute transfers of their funds and/or their economic assets held in Russia. It also allows such entities to apply for licenses to acquire interests held in the entity by the Russian government or a designated person. This amendment allows for Cayman entities to disassociate themselves from sanctioned investments held in Russia or sanctioned investors. Relevant entities are encouraged to discuss with legal counsel to obtain the required licenses by the Cayman Islands authorities.

Global Technology Outage

On July 19, 2024, there was widespread global technology outage following a configuration update to Windows systems which resulted in certain systems crashing. This outage may or may have led to certain financial consequences for entities, such as impacts to results and cashflows, as examples. Entities should consider the need to disclose related information in their annual financial statements or other required disclosures. For SEC filers, this could include disclosing information about the most significant risks of the entity or an investment in its securities. Many filers already include a disclosure related to a general IT disruption risk. That said, this disclosure may need to be tailored if the entity faced a disruption due to the global technology outage, including its actual and future impact. Any impacts to operations or financial condition might also need to be disclosed.

Fund Liquidations

Overview of the voluntary liquidation process

Included below is an overview of the statutory and best practice liquidation procedures as it relates to Cayman Islands investment funds registered as exempted companies or exempted limited partnerships under the Mutual Funds Act and the Private Funds Act.

Funds that have reached their end of life can benefit from commencing a voluntary liquidation as there is potential for cost savings as a result of reduced or eliminated service provider fees. For example, CIMA does not require audited financial statements from a registered fund from the date of commencement of the winding up where third-party liquidator(s) have been appointed. In addition, it may be possible for a fund to obtain an audit exemption for the stub period covering the date of the last audit to the date of the commencement of the voluntary liquidation. Further information on the CIMA audit exemption is included on page 10.

Pre-appointment and commencement of the voluntary liquidation

Exempted Company

- Directors resolve to cease operations and recommend that the fund be placed into voluntary liquidation.
- Shareholder(s) resolutions[1] are passed by the voting shareholder(s) to place the fund into voluntary liquidation and to appoint the liquidators.
- The fund's solvency is reviewed, and all directors are required to sign a Declaration of Solvency[1].
- The liquidators submit their Consents to Act, the Notice of Voluntary Winding Up, the shareholder(s) resolutions, and the Declaration of Solvency to the Cayman Islands Registrar, at which time their appointment is deemed to take effect.

Exempted Limited Partnership

- Voluntary winding up occurs in accordance with the provisions of the exempted limited partnership agreement (the "LPA"):
  - At the time or upon occurrence of any event specified in the LPA; or
  - If not specified in the LPA, upon the passing of a resolution of the general partner(s) and a two-thirds majority of limited partners.
- The liquidators submit the Notice of Voluntary Winding Up and resolution (as applicable) to the Cayman Islands Registrar, at which time their appointment is deemed to take effect.

Immediate actions following the commencement of the voluntary liquidation

- Upon appointment, the liquidators assume control of the fund and the powers of the directors/general partner automatically cease, except to the extent that the liquidators sanction their continuance.
- The liquidators will publish the Notice of Voluntary Winding Up in the Cayman Islands Gazette.
- CIMA does not require audited financial statements from a registered fund for periods subsequent to the date of commencement of the voluntary liquidation where third-party liquidators[2] have been appointed.

[1] Samples of all documents and guidance through this process can be provided if Deloitte is serving as liquidator.
[2] Per CIMA's Regulatory Policy, a "third party liquidator" means individuals, serving as liquidators in a voluntary liquidation of a fund, who are not the operators or currently engaged service providers (excluding an auditor of the fund).

Ongoing matters

- The liquidators will review relationships with service providers and determine the most appropriate approach to their continuance and/or termination, reviewing costs and continuance of services needed during the liquidation.
- If necessary, the liquidators will manage the wind down of the remaining asset portfolio and take steps to realize any assets to generate maximum value and in accordance with stakeholder preferences.
- Distributions to investors will be instructed as appropriate during the period of the liquidation.
- If the liquidation period extends beyond one year, the liquidators will prepare an annual report and accounts and hold an annual meeting for the voting shareholder(s) (this is a statutory requirement for an exempted company only).
- The liquidators will ensure the fund complies with and meets its regulatory obligations.

Final matters and closure of the voluntary liquidation

- At the conclusion of the liquidation, the liquidators will prepare a final report and accounts and convene the final meeting of the fund (this is a statutory requirement for an exempted company only).
- The liquidators will submit the necessary documentation to CIMA to cancel the fund's registration.
- A Final Return (for an exempted company) or Notice of Dissolution (for an exempted limited partnership) is filed with the Cayman Islands Registrar and, for an exempted company, is deemed to be dissolved three months after the date on which the Final Return is registered.

Factors motivating managers and those charged with governance to explore voluntary liquidations:

Illiquid Assets: Extended timeline to realize illiquid assets for adequate value after the investment vehicle has ceased trading.

Reallocation of Resources: Handing over distressed funds to a reputable third-party liquidator can allow a manager to close its operations or reallocate resources in a more efficient matter.

Operational and Cost Efficiencies: Management may wish to simplify their operations or reduce expenses, through consolidation of service providers and elimination of audit requirements.

Contingent or Uncertain Liabilities: A fund may be subject to contingent or uncertain liabilities preventing it from paying final distributions and proceeding with its dissolution.

Pursuit of Legal Claims: Ongoing legal claims may prevent the fund from winding down its operations requiring ongoing management.

Preservation of Investor Confidence: Management can retain investor confidence by considering and putting into place a strategic plan to wind down the operations of a fund in an efficient manner and to maximize returns to investors.

CIMA audit exemption

The Mutual Funds Act and the Private Funds Act require that CIMA registered Mutual Funds or Private Funds have their financial statements audited annually. In certain circumstances, a Mutual Fund or Private Fund that has reached the end of its life may benefit from seeking an exemption from the requirement to have its final financial statements audited.

This exemption may be granted by CIMA under specific circumstances[3]. One of these circumstances includes where a fund is being voluntarily liquidated and a third-party liquidator[4] has been appointed to undertake a review of the unaudited period preceding the commencement of the voluntary liquidation. A review by a third-party liquidator in lieu of a final audit can result in costs savings for a fund and facilitate the cancellation of its registration with CIMA.

Examples of when to consider an audit exemption

- The costs of an audit outweigh the benefit to investors.
- The investment manager and/or fund administrator has been terminated or has resigned and there is no party responsible for managing the fund or preparing accounting records.
- The fund is winding down and had limited financial activity since the date of its last audit period.

Liquidators' review

- The liquidators must be appointed under terms that require a review of the period since the last financial year end for which an audit has been filed to commencement of the voluntary liquidation.
- The review will cover the following:
  - Review of subscriptions and redemptions;
  - Reconciliations to bank accounts/statements;
  - Agreement of shareholder registers with net asset value statements;
  - Recalculation of performance and management fees;
  - Review of creditors and accruals;
  - Review for solvency; and
  - Report on matters relating to compliance with laws and regulations.
- The liquidators will submit a report summarizing the results of their review and the recommendation to CIMA to provide an exemption (assuming this is the liquidators' conclusion).
- If approved by CIMA the fund does not need to conduct an audit for the relevant period and CIMA will proceed to cancel the fund's registration.

For further information regarding fund liquidations, contact:

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[3] Refer to CIMA's Regulatory Policy - Exemption from Audit Requirement for Mutual Funds or Private Funds.
[4] Per CIMA's Regulatory Policy, a "third-party liquidator" means individuals, serving as liquidators in a voluntary liquidation of a fund, who are not the operators or currently engaged service providers (excluding an auditor of the fund).

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