Deloitte.

Deloitte Cayman Islands Technical Brief for Investment Funds

Accounting, Auditing and Regulatory

January 2024

In this issue

Introduction

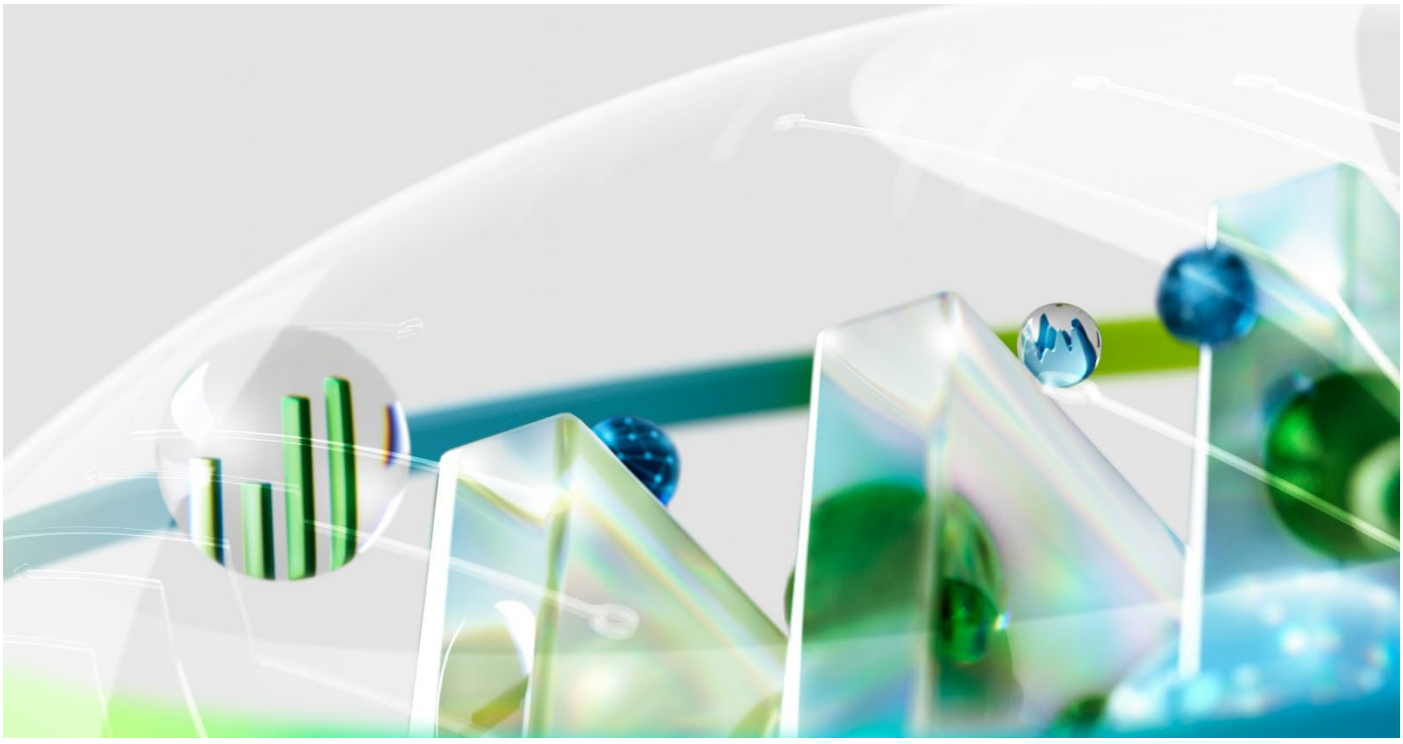
The Technical Brief for Investment Funds ("Tech Brief") is an annual newsletter developed by the Deloitte Cayman Islands Investment Funds Technical Team.

The Cayman Islands investment funds industry continues to exhibit moderate growth, with gains in the number of funds each quarter during 2023. At the end of September 2023, there were approximately 13,000 Mutual Funds (open-ended funds) registered in the Cayman Islands and approximately 16,500 registered Private Funds (closed-ended funds). The approximate 29,500 total registered funds compares to around 28,800 at the end of 2022.

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 will summarize some new and 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 and significant developments that may affect the investment funds industry. We have included a summary of select regulatory matters and some updates to Cayman Islands regulations and laws 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 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 is 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 is 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.

We note there is currently diversity in practice in relation to sale restrictions and the application of restriction discounts. Investment funds may consider early adoption of ASU 2022-03 (both the valuation and incremental disclosure aspects). Investment funds may also consider application of the valuation concepts and conclusions within this ASU without early adopting the full provisions of the ASU (such as the disclosure requirements).

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)

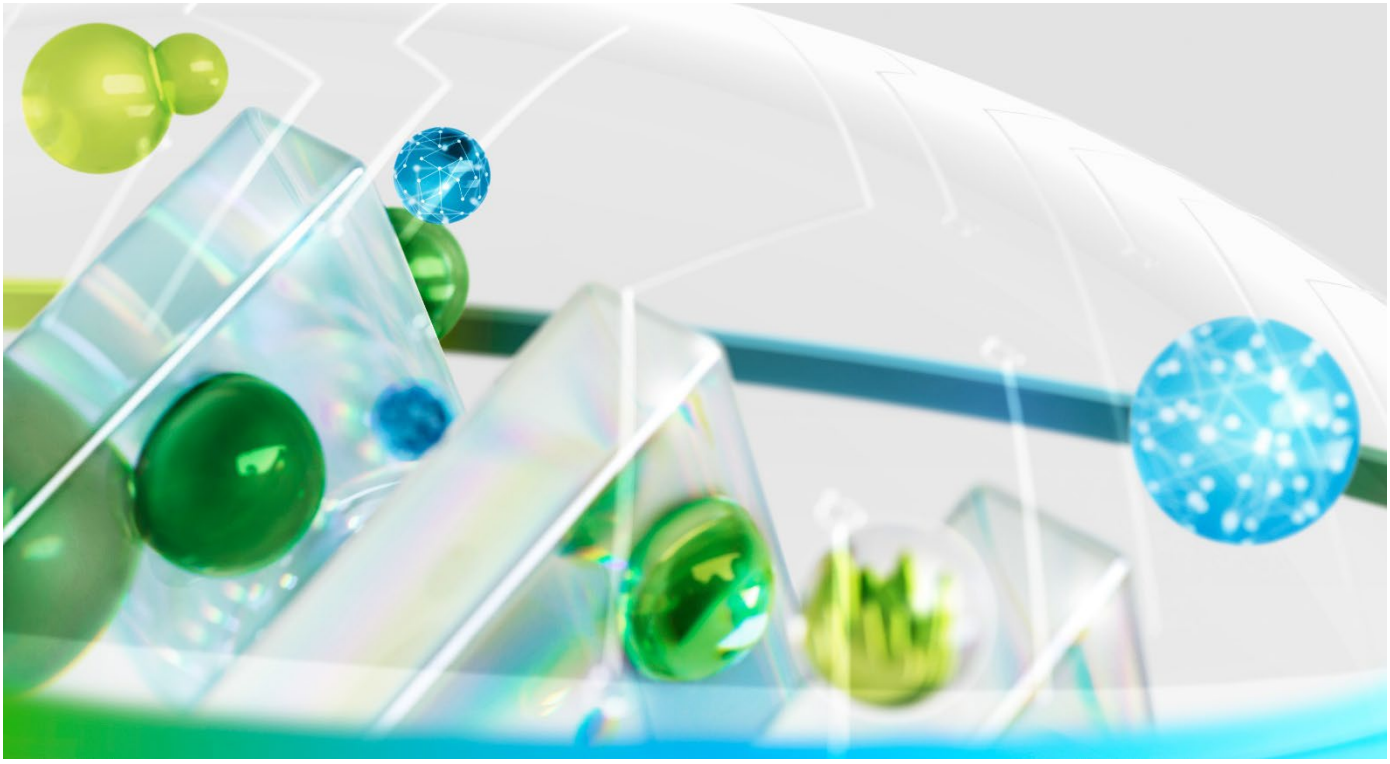
Summary (continued)

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.

In March 2022, the Securities and Exchange Commission ("SEC") shared details of its proposed climate disclosures, which are designed to provide a regulatory framework for ESG. These would require SEC registrants to disclose climate-related information in its registration statements and certain reports, such as Form 10-K. Examples of required disclosures include, but are not limited to, financial statement metrics in its audited financial statements (e.g., whether the carried interest calculation is tied to certain ESG-related metrics), governance of climate-related risks (e.g., whether clients invest in ESG-related projects), impact of climate-related risks on its business and strategy (e.g., whether there are incentive to invest in ESG companies), etc.

In line with the above, the SEC developed the Climate and ESG Task Force in April 2023, which can pursue companies for ESG-related misconduct. Some examples of such misconduct include failing to respect policies regarding ESG investments or misleading ESG considerations.

Investment management companies registered with the SEC should be aware of this proposed framework as they will need to comply with the new regulations, once finalized.

Similarly, other regulators, such as the International Sustainability Standards Board ("ISSB") created by the IFRS Foundation and CIMA have announced the need for standard setting in relation to ESG. ISSB's objective is to create disclosure standards relating to sustainability that companies would need to consider incorporating in their financial statements. Starting January 1, 2024, in the European Union, ESG reporting will be stipulated by the European Sustainability Reporting Standards.

Many audit firms, including Deloitte, are developing 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.

SEC's Enhanced Regulations of Private Fund Advisers

On August 23, 2023, the SEC adopted new rules and amendments that impact private fund advisers. The SEC has stated that these enhanced regulations are meant to protect private funds and their investors.

Some of the new rules and regulations are effective 60 days from the publication date in August 2023. However, some, that could require significant effort to implement, are effective up to 18 months from the publication date. As an example, private fund advisers registered with the SEC will need 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 will be required to distribute fund annual audited financial statements to investors. These are effective as of March 14, 2025. Further, certain activities of all private fund advisers, i.e., whether registered or not with the SEC, will be restricted, unless certain disclosures are made and in certain cases, investor consent is obtained. An example is charging adviser expenses to the fund. This regulation is effective September 14, 2024. The above examples are not the full list of new rules and amendments, which can be found in the SEC's final rule publication dated August 23, 2023.

Private fund advisers should be aware of these new rules and amendments. Although some of these are effective in 2024 and 2025, private fund advisers are encouraged to examine how current practices align with the new requirements and discuss with onshore legal counsel to ensure compliance.

CIMA's New and Updated Regulatory Measures

In April 2023, CIMA released new and updated regulatory measures that apply to all regulated entities. As such, they may impact Cayman Islands funds, such as Mutual Funds and Private Funds.

The new measures are as follows and became effective on October 14, 2023. They are applicable to regulated Mutual funds and Private funds.

- Rule and Statement of Guidance ("SOG") – Internal Controls for Regulated Entities; and
- Rule – Corporate Governance for Regulated Entities

The new rule and SOG on internal controls stipulate that the governing body of a regulated entity is responsible for ensuring that an effective internal control system is in place, including its documentation and its maintenance. The components of such system, as defined in the regulated measure, are the control environment, risk identification and assessment, control activities, information and communication, and monitoring activities.

The new rule on corporate governance introduces the need for a regulated entity to establish, implement, and maintain a corporate governance framework. This framework must address certain points, at a minimum, such as the regulated entity's objectives and strategy, its structure and governance, its risk management and internal control systems, and its allocation of responsibilities, as examples. Further, governing bodies are required to meet at least once a year to review certain practices and identify breaches in compliance.

CIMA recognizes that these new requirements can be applied relative to the size, complexity, nature of business, risk profile and structure of the regulated entity. Outsourcing to service providers to address some of the requirements is also recognized by CIMA.

The updated measures are as follows and became effective on April 14, 2023:

- SOG – Corporate Governance for Mutual Funds and Private Funds;
- SOG – Outsourcing Regulated Entities;
- Rule and SOG - Cybersecurity for Regulated Entities; and
- SOG – Nature, Accessibility and Retention of Records

The updated measures did not introduce significant changes, other than Private Funds now being in scope of the corporate governance SOG, which previously included Mutual Funds only. The rule and SOGs on outsourcing and on cybersecurity do not apply to Private Funds or Mutual Funds.

Regulated entities are encouraged to review the new and updated measures to ensure compliance and establish an appropriate framework. Some of the measures introduce further documentation, meeting, and reporting requirements.

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. In March 2023, CIMA proposed seven bills to strengthen its sanction and enforcement regime. These bills would allow CIMA to apply sanctions to all legal persons under its supervision and to individuals involved in their management. Further, if criminal conduct should be discovered, CIMA would be allowed to share non-public information with overseas authorities.

In August 2023, the Cayman Islands published the Beneficial Ownership Transparency Act 2023 ("Transparency Act"), which consolidates current beneficial ownership rules from the Companies Act, the Limited Liabilities Companies Act, and the Limited Liability Partnership Act. The Transparency Act was passed into law in December 2023. The new provisions of

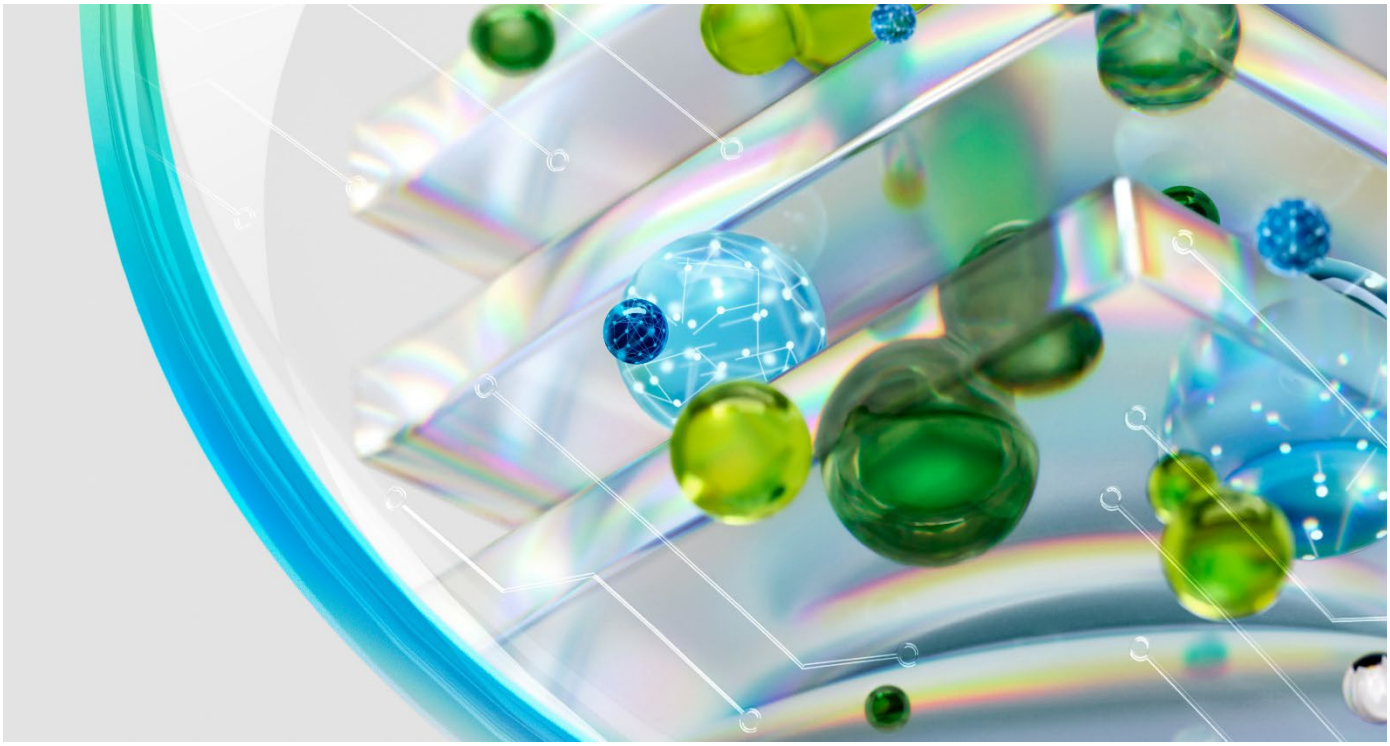
Anti-Money Laundering (continued)

the Transparency Act will come into effect in a phased manner in 2024. Until then, the existing beneficial ownership rules are in force. The Transparency Act includes some changes to the current 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 Transparency Act. Such funds will need to identify a beneficial ownership principal point of contact to respond to beneficial ownership requests from relevant particulars. 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 current rules.

Operators of investment funds should remind their service providers of the requirements of AML/CFT regulations, as well as of potential sanctions for non-compliance with AML/CFT. This continues to be an area of focus by the Cayman Islands. In January 2023, there was a release of a revised publication of the Cayman Islands anti-money laundering ("AML") regulations, which consolidates all amendments made to AML since its initial release in 2020. This could facilitate the compliance of the said regulations.

Refund of Private Fund Segregated Portfolio Fees

In March 2023, CIMA announced that it will no longer collect segregated portfolio annual registration fees for private fund segregated portfolio companies. CIMA will also be refunding any such fees paid as of 2020. Service providers should be aware of this to ensure that the refund is adequately processed and that fees are no longer paid.



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 in the subsequent page.

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 is filed with the Cayman Islands Registrar and the fund 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 in circumstances where a fund is being voluntarily liquidated and a third-party liquidator[3] 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:

Grant Hiley
Partner, Financial Advisory
Tel: +1 (345) 743 6265
Email: granthiley@deloitte.com

Kirsten Cellier
Senior Manager, Financial Advisory
Tel: +1 (345) 743 6271
Email: kicellier@deloitte.com

[3] 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).

Contact Information

Deloitte in the Cayman Islands—Investment Funds Technical Team

Dale Babiuk
Partner
Tel: +1 (345) 743 6225
Email: dbabiuk@deloitte.com

Laurie Mernett
Partner
Tel: +1 (345) 743 6261
Email: lamernett@deloitte.com

Daniel Florek
Partner
Tel: +1 (345) 743 6226
Email: dflorek@deloitte.com

John Jabs
Director
Tel: +1 (345) 743 6369
Email: jojabs@deloitte.com

Lawrence Usher
Director
Tel: +1 (345) 743 6352
Email: lusher@deloitte.com

Justine Freese
Senior Manager
Tel: +1 (345) 743 6274
Email: jufreese@deloitte.com

Viktor Pomazan
Senior Manager
Tel: +1 (345) 743 6314
Email: vpomazan@deloitte.com

Elizna Van der Wal
Manager
Tel: +1 (345) 743 6339
Email: evanderwal@deloitte.com

Deloitte.