Cayman Islands
Assurance and Advisory Services

Technical Brief for Investment Funds

Accounting, Financial Reporting & Regulatory

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Introduction

Welcome to Volume 3 of the *Technical Brief for Investment Funds (“Tech Brief”)*, a periodic newsletter developed by the Deloitte Cayman Investment Funds Technical Team.

Compared to the three-year period ending 2009, the major accounting standard setting bodies have issued relatively few new pronouncements and reporting requirements in the current year that impact investment funds. There are, however, some new requirements and this *Tech Brief* provides a summary. In this *Tech Brief* we also offer observations on two existing accounting standards that have proved problematic with some reporting entities over the past year.

There have been developments on the legislative and regulatory front over the last year that significantly affect the investment management industry. This *Tech Brief* summarizes some of the developments and provides links to some useful resources.

Finally, we summarize some considerations in relation to fund liquidations in the Cayman Islands, and have embedded a more detailed document that will be of use to practitioners. We also touch on one aspect of fund liquidations as they relate to funds managed by SEC-registered advisers.

We issued our two previous *Tech Brief* documents in September 2009 and February 2010, links to which are available at the end of this document. Readers might find it helpful referring to the previous versions of the *Tech Brief* in addition to this volume to obtain a more complete understanding of developments over the past year.

We welcome any comments or suggestions for future issues. Our contact details appear on the last page of this *Tech Brief*.

Recent US Generally Accepted Accounting Principles ("US GAAP") update – Amendments to ASC 820 *Fair Value Measurements and Disclosures* ("ASC 820") (amendments issued through release of Accounting Standards Update ("ASU") 2010-06 *Improving Disclosures about Fair Value Measurements)*

Status – The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the Level 3 roll forward, which are effective for fiscal years beginning after December 15, 2010.

Summary – The ASU provides amendments to ASC 820 that require new disclosures including transfers in or out of Levels 1 and 2, and gross rather than net disclosure in the reconciliation of Level 3 financial instruments. In addition, the ASU provides amendments clarifying existing disclosures in relation to determining the appropriate classes of assets and liabilities used in the tabular disclosure of Level 1, 2, and 3 instruments and disclosures about valuation techniques used for Level 2 and 3 measurements.

Effect on the fair value hierarchy:

Non-derivative instruments

Reporting entities will now be required to provide hierarchical information for each "class" of assets and liabilities, rather than each "major category" of assets and liabilities as in prior years. The effect of these amendments will be a greater level of disaggregation in the fair value hierarchy. Application of these amendments will require judgment, but the guidance instructs preparers to determine "class" based on the nature and risks of the investments. The guidance suggests preparers consider the following factors in determining the class of non-derivative instruments: shared activity or business sector, geographic concentration, credit quality, vintage and economic characteristics.

In an investment fund, the level of disaggregation is also affected by the degree to which assets and liabilities are distributed across hierarchy levels. Unlike other reporting entities, an investment fund is required under a different accounting standard to separately disclose a full or condensed schedule of investments that provides disaggregated information about its portfolio of investments. Therefore if, for example, a portfolio of equity securities is comprised of positions categorized entirely within Level 1 of the fair value hierarchy, an investment fund may desire to present a single line item for equity securities in its fair value hierarchy table, with the reader referring to the schedule of investments for the composition of this line item. If, on the other hand, a portfolio of equity securities is comprised of positions categorized in multiple levels of the fair value hierarchy, then the fair value hierarchy table will have to be disaggregated at least to the level that provides the reader information as to classes of equity securities that comprise each level within the hierarchy.

Derivative instruments

For purposes of the fair value hierarchy table, derivative instruments must now be aggregated by underlying risk exposure (such as interest rate, equity, commodity, currency etc.) rather than by contract type (such as swaps, options etc.), in a manner consistent with ASC 815 (see separate section of this *Tech Brief* for further information on ASC 815). Aggregating in this manner will differ from how derivative instruments are generally grouped within the separate schedule of investments.

The level of further disaggregation within each underlying risk exposure will depend on the degree to which that risk exposure contains instruments distributed across multiple levels in the fair value hierarchy. Therefore if, for example, all currency derivatives are in Level 1, no further disaggregation is needed. If, on the other hand, currency derivatives are comprised of instruments across hierarchy levels, a greater degree of disaggregation is required.

Effect on the roll forward of Level 3 securities:

The standard now requires the Level 3 roll forward to be disaggregated in a manner consistent with the fair value hierarchy described above. In 2009, the Level 3 roll forward was presented in a highly aggregated manner. Level 3 asset and liability derivative classes can be presented gross or net for roll forward purposes.

Significant transfers in or out of Level 3 are to be presented on a gross basis (in and out).

The reporting entity shall disclose and consistently follow its policy for when transfers between levels are recognized (beginning of period in which change in circumstances occurred, actual date of change, end of period in which change occurred). The same policy must be used for transfers in or out of any level. The reasons for significant transfers are also to be disclosed.

Other:

Although there are no roll forwards of Level 1 or Level 2 securities, any significant transfers in or out of Level 1 or Level 2 securities must be disclosed. This can be done in a tabular or narrative format.

For fiscal years beginning after December 15, 2010, the Level 3 roll forward will need to separately present information about purchases, sales, issuances and settlements on a gross basis rather than the current requirement of one net number for all activity.

Recent US GAAP update – Amendments to ASC 810 Consolidation ("ASC 810") (amendments issued through release of ASU 2010-10 *Amendments to ASC 810 for Certain Investment Funds)*

Status – The amendments are effective for fiscal years commencing after November 15, 2009. Early application is not permitted.

Summary – In June 2009, the Financial Accounting Standards Board ("FASB") issued Statement 167, *Amendments to FASB Interpretation No. 46(R)* ("FAS 167"). FAS 167 was applicable for annual periods commencing after November 15, 2009. The requirements of FAS 167 are now embedded within ASC 810. When FAS 167 was released, investment managers of investment funds expressed concern about the possible consolidation of certain investment funds into their financial statements under the revised control model within FAS 167, and that the resulting consolidation would not provide useful information to users of the investment manager's financial statements. The FASB agreed with such a concern, as well as comments received that the consolidation model under FAS 167 differed, in effect, from existing and proposed consolidation models under International Financial Reporting Standards ("IFRS") that would be applicable to an investment manager's circumstances, and issued for comment a proposed

ASU in December 2009 to defer indefinitely the application of FAS 167 to interests in investment funds in most circumstances.

In January 2010 the FASB voted to finalize the proposed ASU, and the ASU was issued in February 2010. The ASU defers indefinitely the requirement for a reporting enterprise (e.g. an investment manager) to consolidate its interest in an entity if the underlying entity meets all of the following conditions:

(1) The underlying entity has all of the attributes specified in paragraphs 15-2(a)-(d) of ASC 946-10 (that is, it has the attributes that are typically characteristic of an investment fund) or it is an entity for which it is industry practice to apply guidance that is consistent with the measurement principles in ASC 946 Investment Companies for financial reporting purposes. Examples include mutual funds, hedge funds, private equity funds, mortgage real estate investment funds and venture capital funds.

(2) The reporting enterprise does not have an obligation to fund losses of the underlying entity that could potentially be significant to the underlying entity.

(3) The underlying entity is not a securitization entity, an asset-backed financing entity, or an entity that was formerly considered a qualifying special purpose entity.

Observations on US GAAP - ASC 740 *Income Taxes* (aspects related to the former FIN 48) – an update – one year later

In our September 2009 *Tech Brief,* we introduced amendments to ASC 740 *Income Taxes* (such amendments were included in what was formerly known as “FIN 48”, and we will use “FIN 48” for convenience within this section) which clarified the accounting for uncertainties in income taxes recognized in an entity’s financial statements. Refer to the September 2009 *Tech Brief* for a description of the content of FIN 48.

In our February 2010 *Tech Brief*, we discussed issues relating to implementing FIN 48 in a fund environment. Of particular practical concern to a fund is the trading of securities in countries that impose capital gains or other income taxes on non-residents, but do not automatically collect the taxes via a withholding or other mechanism. Certain countries have legislation in place that, at least in theory, imposes capital gains taxes on transactions by non-residents. In practice, however, many of these countries, for administrative or other practical reasons, have not historically sought to levy and collect such taxes. Our February 2010 *Tech Brief* discussed several practical issues that this creates, as well as some of the preliminary responses affected investment funds had to contend with FIN 48.

Subsequent to the issuance of our February 2010 *Tech Brief*, we have seen a few other responses to FIN 48 (in addition to those discussed in the February 2010 *Tech Brief)*. These additional responses include:

- <u>Insurance:</u> We have observed that some funds have purchased what has been termed by some ‘FIN 48 insurance’, which is a form of transactional-tax insurance that was offered by several insurers. In exchange for a premium, a fund or fund manager can purchase insurance whereby the insurer agrees to indemnify the insured for potential liabilities associated with uncertain tax positions, including tax, interest and penalties. In practice, we have seen some funds purchase this insurance directly, and charge the premium to the fund itself. In other circumstances, fund managers have purchased such insurance to support any indemnifications the fund manager may have provided to the fund in relation to uncertain tax positions. Premiums from these insurers have varied, depending on a number of factors, including the countries to which such potential taxation liabilities relate to, but, based on our observations, have ranged between 2 and 4% of the desired policy limit. While FIN 48 insurance was available from several insurance brokers, most have now ceased offering such cover for a variety of reasons, and the availability of such insurance is now quite limited.

- Transacting through entities established in other jurisdictions. Some funds have contemplated establishing a special purpose vehicle below the fund in a jurisdiction that has in place a double-tax treaty with the 'problematic' jurisdictions, and undertake trading activities in securities of such countries through the special purpose vehicle. There are, however, costs and potentially other undesired consequences associated with doing this, and some of the problematic jurisdictions may look through the special purpose vehicle, thereby rendering the special purpose vehicle ineffective at limiting taxation.

- Use of derivatives Rather than investing directly in equity and fixed income securities of the 'problematic' jurisdictions, some funds have instead gained exposure to the securities through the use of derivatives such as swaps or forward contracts. Entering into derivative contracts with a counterparty outside of the problematic jurisdictions rather than investing directly in the underlying asset should remove any concerns relating to capital gains taxes in the problematic jurisdiction. However, excluding the potential effects of taxes, investing through the use of over-the-counter derivatives introduces additional frictional costs, and is generally less efficient than investing directly in the underlying assets. A fund would also have to find a counterparty willing to take the other side of such contract, and a potential counterparty may face taxation consequences of its own it such counterparty desires to hedge its position by, for example, acquiring the underlying security.

Many countries had initially been identified as problematic from a FIN 48 perspective, and included Australia, Brazil, Germany, Portugal, Poland and Spain. Many practitioners have removed from this list Australia, based on past administrative practices of that jurisdiction. On the other hand, most practitioners have gone in the other direction with Spain, given some informal representations by Spanish taxation authorities affirming a desire to collect, or establish an administrative apparatus to collect, capital gains taxes on non-resident persons and entities holding Spanish equities.

Observations on US GAAP – ASC 815, *Derivatives and Hedging* ("ASC 815") – common deficiencies

In our September 2009 *Tech Brief* (a link to which can be found later in this newsletter), we introduced amendments to ASC 815. The amendments required certain additional qualitative and quantitative disclosures relating to derivative instruments. These amendments were effective for December 31, 2009 year ends.

For the most part, we observed that investment funds adopted the full provisions of the amended standard. However, we did observe instances of non-compliance with certain aspects of the amended standard. Some of the more common deficiencies were as follows:

- Quantitative information presented by contract type rather than risk exposure: ASC 815 requires various quantitative disclosures presented in the notes to financial statements. ASC 815 requires such information to be aggregated by underlying risk exposure (such as interest rate, equity, commodity, currency etc.) rather than by contract type (such as swaps, options etc). In some circumstances, this proved challenging for financial statement preparers, as internal accounting systems typically aggregate information by contract type, requiring preparers to then also re-aggregate the same information by underlying risk exposure.

- Entities with derivative activity during reporting period with no derivative positions at period end. In some circumstances, entities without any derivative positions at period end overlooked the required disclosures unrelated to period-end positions. ASC 815 requires other qualitative and quantitative disclosures, including objectives for using derivative instruments during the period, context needed to understand those objectives, the strategies used for achieving those objectives, the volume of activity during the year and the tabular disclosures showing the effect on the income statement.

- Information required to be presented in tabular format was presented in narrative form. In order to provide for a degree of consistency and comparability across reporting entities, ASC 815 provides that certain of the required quantitative disclosures are to be presented in a tabular format. Prior to 2009 year ends, a reporting entity may have had existing derivative disclosures in another format, and the reporting entity maintained such disclosures for the 2009 year end, without amending or augmenting such disclosures in accordance with the required tabular disclosures.

- Omitted qualitative disclosures**.** ASC 815 requires a number of qualitative disclosures in addition to required quantitative disclosures. We observed that practitioners had a greater degree of awareness of the quantitative disclosures, but a lesser degree of awareness of the required qualitative disclosures, presumably because the quantitative disclosures required more, and in some cases substantially more, preparation effort and therefore received greater focus. As a result, we observed some instances of omission of certain qualitative disclosures.

Regulatory Update – US - Dodd-Frank Act

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Dodd-Frank Act is comprehensive, and affects almost every aspect of the US financial services industry, and non-US financial services industry to the extent of US activities. Two aspects of the Dodd-Frank Act that particularly impact the investment fund industry are the new private fund registration requirements and the so-called "Volcker Rule".

Regulatory Update – US- Dodd-Frank Act – private fund registration and other requirements

Title IV of the Dodd-Frank Act contains provisions relating to regulation of advisers to private investment funds. Such provisions included in Title IV can also be cited by the following short title: "Private Fund Investment Advisers Registration Act of 2010".

On November 19, 2010, the SEC issued for comment *Rules Implementing Amendments to the Investment Advisers Act of 1940*, in which the SEC proposed new rules and rule amendments to implement certain provisions of Title IV of the Dodd-Frank Act.

On November 19, 2010, the SEC also issued for comment *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers.* These proposed rules would give effect to new exemptions from the SEC registration requirements for advisers to certain privately offered investment funds that were enacted as part of Title IV of Dodd-Frank Act. The proposed rules would also clarify the meaning of certain terms included in Title IV of the Dodd-Frank Act.

Advisers required to register pursuant to the Dodd-Frank Act must do so by July 21, 2011.

Fund advisers required to register with the Securities and Exchange Commission ("SEC")

The Dodd-Frank Act changes the criteria for the determination of which fund advisers are required to register with the SEC. Prior to the Dodd-Frank Act, many currently unregistered private fund advisers relied on the so called "private adviser exemption", which exempts fund advisers from registration if they meet all of the following:

- Do not manage any SEC-registered funds; and
- do not hold themselves out to the public to be investment advisers; and
- have fewer than 15 "clients". For purposes of the determination of what is deemed a "client", a fund is considered to be one client (i.e., no 'look-through' to underlying investors).

The Dodd-Frank Act eliminates the "private adviser exemption", and in particular the 15-client count criterion, and introduces asset-level exemptions. Unless the adviser qualifies for one of the further specific exemptions, as discussed in other sections below, advisers to private funds will now be required to register with the SEC, regardless of the number of clients, unless the adviser has assets under management in the US of less than $150 million. This small private fund adviser exemption applies only to advisers whose sole clients are private funds. If a fund adviser also has managed accounts or other non-fund clients, the $150 million small private fund adviser exemption wouldn't apply (and a lower exemption amount for advisers in general of $100 million would apply).

Fund advisers not permitted to register with the SEC

Some private fund advisers have previously voluntarily registered with the SEC for various reasons, including avoiding having to register in multiple individual states. The Dodd-Frank Act will continue to permit private fund advisers to voluntarily register, provided they have at least $100 million of assets under management in the US. If a currently registered fund adviser has less than $100 million assets under management, they will be required to deregister from the SEC, and register instead with the applicable state(s). There are some notable exceptions to this, including if the respective state doesn't have a regulatory examination regime, and if state registration would cause the adviser to register in 15 or more states. In such circumstances, the fund adviser would be permitted to register with the SEC. Registration with multiple states may increase the regulatory cost and time burden on fund advisers, as well as being potentially subject to a disparate set of regulatory regimes.

Non-US advisers

A non-US adviser (termed a "foreign private adviser" under the Dodd-Frank Act) would be exempt from registration with the SEC if it meets certain specific criteria. A "foreign private adviser" is an adviser that:

- Has no place of business in the US; and
- has fewer than 15 clients and investors in the US in private funds advised by the adviser; and
- has aggregate assets under management attributable to clients and investors in the US in private funds of less than $25 million.

Venture capital fund advisers

The Dodd-Frank Act exempts from registration advisers to "venture capital funds". The Dodd-Frank Act did not define "venture capital fund", but rather instructed the SEC to issue rules to define such term. On November 19, 2010, the SEC proposed a definition of "venture capital fund", as discussed further below. The exemption afforded to advisers to venture capital funds applies only if the adviser acts solely to one or more venture capital funds, and not also to other clients, such as managed accounts.

In its proposed rules issued November 19, 2010, the SEC defines a venture capital fund as a private fund that:

- Invests in equity securities of private companies in order to provide operating and business expansion capital (i.e., so called "qualifying portfolio companies", as defined below) and at least 80 percent of each company's securities owned by the fund were acquired directly from the qualifying portfolio company;
- directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company;
- does not borrow or otherwise incur leverage (other than limited short-term borrowing);
- does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;
- represents itself as a venture capital fund to investors; and
- is not registered under the Investment Company Act and has not elected to be treated as a business development company.

The SEC proposes to define a "qualifying portfolio company" in its November 19, 2010 proposed rules as any company that:

- Is not publicly traded;
- does not incur leverage in connection with the investment by the private fund;
- uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and
- is not itself a fund (ie. is an operating company)

The proposed rules also contain a more generalized venture capital fund exemption for purposes of grandfathering certain existing venture capital funds.

Other advisers exempt from registration

The Dodd-Frank Act provides registration exemptions for certain other advisers, including family offices (to be defined by the SEC, a proposed definition of which has been issued by the SEC for comment), certain advisers registered with the Commodity Futures Trading Commission, and advisers that solely advise small business investment companies.

Reporting and other ongoing requirements of SEC advisers

Newly registered advisers will need to comply with existing requirements that existing registrants are currently subject to, including:

- Subject to SEC inspection
- SEC Custody Rules
- Develop a compliance program and procedures
- Appoint a Chief Compliance Officer
- Develop a code of ethics.
- Other requirements

The Dodd-Frank Act introduces further requirements for records and reports to be maintained by the adviser, with such reports and records subject to inspection by the SEC. Some of this information will be reported on the revised Form ADV to be completed by the adviser (see section blow). Such requirements include the maintenance of a description of:

- Assets under management and use of leverage, including off balance-sheet leverage
- Counterparty credit risk exposure
- Trading and investment positions
- Valuation policies and practices of the fund
- Types of assets held
- Side arrangements or side letters
- Trading practices
- Other information as the SEC deems appropriate for the protection of investors or for the assessment of systemic risk

Proposed amended information reported on Form ADV

The November 19, 2010 proposed implementation rules issued by the SEC expands on the information currently required to be reported in Form ADV by fund advisers in order to provide the SEC and the investing public with basic organizational, operational and investment characteristics of funds advised by the adviser; the amount of assets held by the funds; the nature of the investors in the funds; and the funds' service providers. This information provided by the fund adviser will become publicly available. Some of the additional information to be reported includes:

- Identification of state or country where fund is organized;
- names of the general partner, trustee, directors or similar persons;
- regulatory status of the fund and whether adviser is subject to foreign regulation;
- size of fund, including gross and net assets (as an indicator of on-balance-sheet leverage);
- investment strategy of the fund;
- breakdown of assets and liabilities by US GAAP fair value hierarchy;
- "types" of investors and minimum investor subscription amounts;
- various information on the so-called five "gatekeepers" of the fund (i.e., auditors, prime brokers, custodians, administrators and marketers).

Accredited Investor standard

Title IV of the Dodd-Frank Act adjusts the definition of an "Accredited Investor". The Dodd-Frank Act maintains a $1,000,000 net worth threshold at the time of purchase of an investment in a private fund, but now excludes from this net worth determination the value of the primary residence of such investor. The Dodd-Frank Act further provides that such definition shall be revisited once every four years.

Regulatory Update – US - Dodd-Frank Act: Volcker Rule Restrictions

The so-called 'Volcker Rule' components (termed the 'Volcker Rule' after a similar set of rules proposed by Paul Volcker, a former US Federal Reserve Chairman) of the Dodd-Frank Act dictate that, subject to rules and certain exceptions, any "banking entity" (generally defined as an insured depository institution), and any affiliate or subsidiary of any such entity, will generally be prohibited from:

- Engaging in 'proprietary trading'. Proprietary trading is defined as engaging as a principal for the trading account of a banking entity. Trading account in turn is defined as any account used for taking positions in securities/ instruments principally for the purpose of selling in the near term or transactions that involve short-term price movements;
- acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund that would, in aggregate, exceed 3% of the banking entity's Tier 1 capital;
- sponsoring a hedge fund or private equity fund. Sponsoring is generally defined as serving as a general partner, managing partner, trustee, controlling directors/trustee, or sharing a common name.

Although the above activities will be prohibited by the Volcker Rule, certain other banking-related activities, such as asset-backed securitization will still be permitted with certain limitations. Securitizers must retain 5% of the credit risk of assets transferred/sold through issuance of asset-backed securities.

The Volcker Rule applies to US banking organizations, regardless of where the trading or activities are centered. For non-US banking organizations, the Volcker Rule is applicable for any trading and fund activities in the US, or activities outside of the US if such activities involve offering securities to any US resident. The effective date of the Volcker rule is 12 months after issuance of final regulations, but no later than July 2012 (2 years after the passage of the Dodd-Frank Act), should final regulations not be issued at that stage.

Regulatory Update – US - Securities and Exchange Commission ("SEC") Custody Rule

In our February 2010 *Tech Brief,* we touched upon amendments that were issued by the SEC to the custody requirements of Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule"), which were intended to increase protections for investors who entrust assets to advisers who are registered with the SEC. The amendments to the Custody Rule contain a number of key provisions related to: independent verification, internal control reports, delivery of account statements, additional disclosures and qualified custodians.

In relation to the Custody Rule, custody refers to an investment adviser holding, directly or indirectly, client funds or securities or having any authority to obtain possession of them. Custody in the context of the Custody Rule refers to more than just physical custody, and most advisers to investment funds are deemed to have custody of investors' invested capital.

The impact of these amendments on investment funds managed by SEC-registered advisers is not significant in most circumstances, to the extent the adviser relies on the audited financial statements to satisfy the requirements of the Custody Rule. There are some circumstances where there may be a greater impact of the amendments on a fund adviser, such as, for example, where the adviser or an entity related to the adviser serves as the custodian of a fund's assets (in such circumstances, the adviser would be required to obtain a SAS 70 report on the custody controls at such custodian).

Subsequent to the release of the amended Custody Rule, a number of additional clarifying frequently asked questions and answers have been developed by the SEC in relation to the Custody Rule.

The Custody Rule can be found at www.sec.gov/rules/final/2009/ia-2968fr.pdf

The frequently asked questions can be found at Staff Responses to Questions About the Custody Rule

Eligible auditors of funds managed by SEC registered advisers

In order for a fund adviser registered with the SEC to use the audited financial statements to satisfy certain of its requirements under the Custody Rule, the adviser must engage an independent auditor that is **both** a) registered with the Public Company Accounting Oversight Board ("PCAOB") and b) subject to regular inspection by the PCAOB.

Any audit firm can register with the PCAOB, but only certain audit firms are subject to inspection by the PCAOB. If an auditor isn't subject to inspection, the PCAOB has no authority to inspect the audit firm. An audit firm is subject to inspection if it either audits an "issuer" (an issuer is a public company that is required to file reports with the SEC or that has filed a registration statement with the SEC for a public offering of securities), or plays a "substantial role", as defined, in the furnishing of an audit report with respect to an issuer.

If an auditor is not subject to inspection pursuant to the two circumstances above, the auditor is ineligible to perform the annual audit for purposes of the Custody Rule. Note that auditing funds of an SEC registered adviser does not make an auditor subject to inspection, as the funds are not deemed to be an 'issuer'.

[Note: Deloitte Cayman Islands is registered with the PCAOB and is subject to inspection by the PCAOB. There are four other audit firms in the Cayman Islands that are registered with and subject to inspection by the PCAOB (as of November 2010)].

Under the revised Form ADV to be completed annually by the registered adviser, the registered adviser is required to positively affirm whether the independent public accountant is registered with, and subject to inspection by, the PCAOB.

Regulatory Update – US - Foreign Account Tax Compliance Act ("FATCA")

On March 18, 2010, the *Hiring Incentives to Restore Employment* ("HIRE") Act was signed into law in the US which included provisions of FATCA. The purpose of FATCA is to impede the use of foreign accounts by U.S. persons/taxable entities for the purpose of evading U.S. taxes.

Beginning in 2013, FATCA will require foreign financial institutions ("FFIs"), including investment vehicles, which receive any U.S. source income (directly or indirectly) to either have an information reporting agreement with the U.S. Treasury ("FFI Agreement") or be subject to a withholding tax equal to 30 percent on any withholdable payment. A withholdable payment includes U.S. sourced interest, dividends and other profits as well as the gross proceeds from the sale or disposition of any assets that could produce interest or dividends from U.S. sources (including total return swaps on U.S. entities).

Under an annual FFI Agreement, the FFI will need to obtain information from each of its account holders to determine if it is owned by U.S. persons/taxable entities and report information to the U.S. Treasury relating to those U.S. accounts.

The FATCA implementation process is evolving, with regulations being issued periodically. For up to date information on FATCA, please visit the Deloitte FATCA Resource Library at:

http://www.deloitte.com/view/en_US/us/Services/tax/Tax-Controversy-Services/Tax-Information-Reporting-Tax/fatca/index.htm

Regulatory Update – Cayman Islands Monetary Authority

The Cayman Islands Monetary Authority ("CIMA") has released for public comment a Draft Rule on Regulatory Reporting Standards (the "Draft Rule"). This Draft Rule establishes policies and procedures for imposing administrative penalties related to filing deadlines and extensions for regulatory reporting. If a regulated entity (such as a regulated investment fund) exceeds the filing deadline or granted extension period (collectively, the "due date"), the proposed administrative penalties are as follows (all expressed in Cayman Islands dollars):

- Within 10 business days following the due date: $500;
- More than 10 business days following the due date: $500 above plus $100 per day, subject to a maximum penalty of $5,000.

A payment notice will be issued at the earlier of the entity's submission of the regulatory report or the administrative penalty accruing to the maximum of $5,000. The payment notice must be paid within 30 calendar days of the penalty being issued. The administrative penalty will also form part of the entity's compliance record at CIMA.

In addition, the Draft Rule introduces filing extension application due dates, such that the due date for regulated mutual funds (as defined by the Mutual Funds Law (2009 Revision)) is 30 calendar days; the due date for other reporting entities is 7 calendar days. A $250 fee must accompany such extension application; such extension fee was introduced for the December 31, 2009 reporting period.

As the Draft Rule remains in draft form and subject to change, its implementation will occur after the December 31, 2010 reporting period.

Regulatory Update – EU - Alternative Investment Fund Managers Directive

Following a long consultation process, the final terms of the Alternative Investment Fund Managers Directive (the "Directive") were approved by the European Plenary Council on November 11, 2010 ending a great deal of uncertainty for the investment management industry. The Directive will apply to alternative investment fund managers ("AIFM") established within and outside the EU who are actively marketing to EU investors. While the Directive introduces a number of operational and compliance requirements for AIFMs, this summary focuses more on one aspect of the Directive – the ability to market Cayman Islands funds to investors based in the EU.

The Directive introduces a marketing passport system which enables an AIFM to market to investors in all EU Members States upon meeting the authorization requirements. This passport is expected to be introduced in 2013 for EU funds and in 2015 for non EU funds. In the meantime, EU and non EU AIFMs may continue using the existing national private placement rules to distribute non EU funds until at least 2018, subject to meeting certain new conditions. After the EU Parliament's vote on the Directive, the position may be summarized as follows:

EU AIFM managing EU Fund	• Distribute under an EU Passport (from 2013) ➢ Must comply with the Directive in full
EU AIFM managing/ marketing non-EU Fund	Option to: • Distribute under EU Passport (from 2015) ➢ Must comply with the Directive in full ➢ Must meet cooperation provisions (see below) or • Distribute under harmonised national private placement regimes (until at least 2018) ➢ Must comply with the Directive in full excluding Article 21 (which relates to depositaries) ➢ Must meet cooperation provisions (see below)
Non-EU AIFM managing non-EU fund	Option to: • Distribute under EU Passport (from 2015) ➢ Must comply with the Directive in full ➢ Must meet cooperation provisions and additional conditions (see below) or • Continue to distribute under harmonised national private placement national regimes (until at least 2018) ➢ Must comply with the Directive provisions related to transparency and private equity rules ➢ Must meet cooperation provisions (see below)

Cooperation provisions

1. Cooperation agreements need to exist between the competent authorities in the EU member state where the AIFM is authorized and the competent authorities in the jurisdictions where the Fund and the AIFM are established.

   Cayman commentary – CIMA has a number of co-operation agreements in place with many regulators including the FSA in the UK. In addition, CIMA is a member of International Organization of Securities Commissions ("IOSCO") and a signatory to IOSCO's multilateral memorandum of understanding which the regulators of 24 EU member states are also a signatory. CIMA have met with EU officials on the Directive and are committed to making the necessary changes to ensure the Cayman Islands are fully compliant.

2. The jurisdiction where the fund and/or the AIFM is established must not be listed as a non-cooperative country by the Financial Action Task Force ("FATF") on anti-money laundering and terrorist financing.

   Cayman commentary - The Cayman Islands anti-money laundering/anti terrorist legislation has been reviewed and received high ratings from the FATF.

3. Taxation agreements need to exist between each EU member state where the fund is to be distributed and the jurisdiction where the AIFM and/or the fund is established (only required for EU passport)

   Cayman commentary - The Cayman Islands is on the OECD White List and currently has 20 (as of October 2010) tax information exchange agreements in place including, Denmark, Finland, France, Germany, Italy, Ireland, the Netherlands, Portugal, Sweden, and the UK. The Cayman Islands Government will seek to enter into agreements with the remaining EU member states.

Additional conditions

1. Legal representative within the EU.

2. Local regulation is not incompatible with the Directive.

What does this mean for US based investment managers?

A US based investment manager can continue to market their Cayman Islands fund to EU investors, without complying with the Directive in full, by following the national private placement rules until at least 2018 provided they meet cooperation provisions 1 and 2 as well as some transparency requirements. It is worth noting that the Directive does not prevent passive marketing or reverse solicitation of EU investors by non EU AIFM. This means that US investments managers could continue to have EU investors without being subject to the full Directive as long as they are not actively marketing the fund in the EU.

It is also important to note that while the passport system and the private placement rules will co-exist for a period of time, it is entirely possible that the private placement rules could continue after 2018 should the key policy makers in the EU believe that the passport system is not meeting its intended objectives.

The Directive will be published in early 2011 and will then undergo "level 2" rulemaking to establish the technical aspects of the Directive. In the meantime, the Cayman Islands private sector will continue to monitor the progress of the Directive while the Cayman Islands Government reviews the legislative changes required to allow AIFMs to continue distributing Cayman funds to EU investors.

International Accounting and Auditing Standards Update

Accounting

There have not been any changes to International Financial Reporting Standards that will significantly impact the 2010 reports. There are a few changes in the exposure draft process, as well a number of changes that are being contemplated in ongoing projects undertaken by the International Accounting Standards Board. None of these proposed or contemplated changes will be effective prior to December 31, 2010.

Auditing

As part of the International Auditing and Assurance Standards Board's ("IAASB") "Clarity Project", a number of auditing standards were reissued. These reissued standards are effective for audits of financial statements for periods beginning after December 15, 2009. The impetus for the Clarity Project was a recognition by the IAASB that standards need to be understandable, clear, and capable of consistent application. The intent is that these aspects of clarity will function to enhance the quality and uniformity of practice worldwide. The Clarity Project involved the application of new drafting conventions to all International Standards on Auditing, either as part of a substantive revision or through a limited redrafting, to reflect the new conventions and matters of clarity generally.

Non-auditor service providers to investment funds will not likely notice any substantial changes to the audit process. Readers of financial statements will notice some small changes to the wording of the standard auditors' report.

Fund liquidations – Cayman Islands and SEC matters

Cayman Islands considerations

Stakeholders of investment funds domiciled in the Cayman Islands may periodically encounter circumstances where a fund has reached the end of its operating life and is placed into voluntary liquidation. Stakeholders may be unfamiliar as to the process, timing and other practical issues relating to a Cayman voluntary liquidation. In addition, there are various decisions and considerations that need to be contemplated by stakeholders. Directors of investment funds in particular have added considerations and responsibilities in the liquidation process as a result of new legislation put into place in Cayman in March of 2009.

To aid practitioners in understanding the voluntary liquidation process, our Deloitte Cayman Financial Advisory Services group has drafted the attached document *Voluntary liquidation of regulated Cayman Islands Funds – Considerations for all stakeholders.* Any questions practitioners might have regarding the voluntary liquidation process can be addressed to the Deloitte Cayman professionals listed in the following document.

SEC considerations – audit requirements of liquidating funds

As discussed in the SEC Custody Rule section of this *Tech Brief*, fund advisers registered with the SEC commonly distribute audited financial statements of their funds to investors to satisfy certain of their obligations pursuant to the SEC's Custody Rule. Prior to the revisions to the Custody Rule, the SEC's expectations were unclear to some practitioners with respect to audit requirements of a fund placed in liquidation. However, revisions to the Custody Rule make explicit the requirement for the adviser to obtain a final audit of the fund's financial statements upon liquidation of the fund, and to distribute the audited financial statements to investors promptly upon completion of the audit. It is the SEC's view that obtaining an audit of the fund upon liquidation provides some assurance that the proceeds of liquidation are properly accounted for so that investors can take timely steps to protect their rights.

The amended Custody Rule did not specify whether the liquidation financial statements should be prepared as of a date prior to final distribution of assets, a date subsequent to the final distribution of assets, or some other date.

Archive: Volume 1 – September 2009 Technical Brief for Investment Companies

www.deloitte.com/assets/Dcom-CaymanIslands/Site%20SMF/EN/Services/Audit/Techbriefforinvcompanies_vol1.pdf

Archive: Volume 2 – February 2010 Technical Brief for Investment Companies

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Cayman Islands
Assurance and Advisory Services

Deloitte Cayman Investment Funds Technical Team

Dale Babiuk, CA, CFA
Partner | Email: dbabiuk@deloitte.com

Norm McGregor, CA, CFA
Partner | Email: nmcgregor@deloitte.com

Anthony P DeAngelis, CPA
Director | Email: antdeangelis@deloitte.com

Carrie Brown, CA, CFA
Director | Email: cabrown@deloitte.com

Daniel Florek, CPA
Senior Manager | Email: dflorek@deloitte.com

Laurie Mernett, CA
Senior Manager | Email: lmernett@deloitte.com

Rod Campbell, CPA
Senior Manager | Email: rodcampbell@deloitte.com

Always one step ahead

Deloitte
One Capital Place
PO Box 1787 Grand Cayman, KY1-1109
Cayman Islands
Main: 1 (345) 949 7500