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Cayman Islands
Assurance and Advisory Services

Technical Brief for Investment Funds

Accounting, Financial Reporting and Regulatory

Volume 7 – January 2015

In this issue:

Introduction

Welcome to Volume 7 of the *Technical Brief for Investment Funds ("Tech Brief")*, an annual newsletter developed by the Deloitte Cayman Islands Investment Funds Technical Team.

The major accounting standard setting bodies have issued a number of new amendments and refinements to guidance over the last couple years, several of which are effective for 2014 year ends. Fortunately for financial statement preparers, the new requirements for 2014 are more limited than in each of the last several years. In this *Tech Brief,* we summarize some of the more significant new and upcoming accounting and financial reporting requirements that investment funds and their managers will have to contend with.

On the regulatory front, there are a number of developments that impact the investment management industry. This *Tech Brief* provides brief updates on a few regulatory matters.

Finally, we summarize some considerations in relation to fund liquidations in the Cayman Islands, and have embedded a link to a more detailed document that will be of use to practitioners. We have also included a sidebar discussion on alternatives to liquidation in circumstances where a fund manager is seeking a wind down of a fund with significant illiquid positions.

Links to our previously issued *Tech Briefs* 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.

United States Generally Accepted Accounting Principles Update

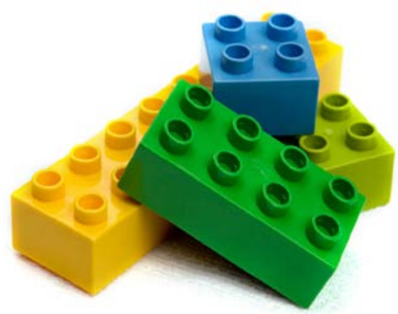
Recent US GAAP Update – Amendments to Financial Services - Investment Companies (Topic 946) *Amendments to the Scope, Measurement and Disclosure Requirements* (amendments issued through the release of ASU 2013-08)

Status – The amendments in this ASU are effective for interim and annual reporting periods in fiscal years that begin after December 15, 2013. Earlier application is prohibited.

Summary - This ASU includes provisions that amend the existing criteria in ASC 946 *Financial Services – Investment Companies* ("ASC 946") for an entity to qualify as an investment company. Specifically, the criteria within the definition are expanded and additional implementation guidance is provided. An entity determined to be an investment company under the amended criteria would measure its investment assets and liabilities at fair value. With the amended definition, certain entities that are currently within the scope of ASC 946 may no longer be investment companies. Conversely, certain entities not currently within the scope of ASC 946 may be investment companies with the amendments.

The main provisions of this ASU are as follows:

- Change the approach to investment company assessment under ASC 946, clarify the characteristics of an investment company, and provide guidance for assessing whether an entity is an investment company;
- Require an investment company to measure non-controlling ownership interests in other investment companies at fair value rather than using the equity method of accounting.
- Additional disclosures: 1) the fact that the entity is an investment company and is applying the guidance in ASC 946, 2) information about changes, if any, in an entity's status as an investment company, and 3) information about financial support provided or contractually required to be provided by an investment company to any of its investees.



The new assessment process is a two-tiered approach, which requires an entity to possess certain fundamental characteristics, while allowing judgment in assessing other typical characteristics. In addition to these characteristics, an entity shall also consider its purpose and design.

The fundamental characteristics are:

- The entity does both of the following:
    a. Obtains funds from one or more investors and provides the investor(s) with investment management services
    b. Commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income, or both

- The entity or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

The typical characteristics of an investment company are:

- It has more than one investment
- It has more than one investor
- It has investors that are not related parties of the parent (if there is a parent) or the investment manager
- It has ownership interests in the form of equity or partnership interests
- It manages substantially all of its investments on a fair value basis.

An investment company shall possess the fundamental characteristics, and, in most cases, all of the typical characteristics. To the extent the entity does not possess all of the typical characteristics, the entity shall apply judgment, considering all of the facts and circumstances, and determine how its activities continue to be consistent (or are not consistent) with those of an investment company. The implementation guidance within the ASU provides guidance in making this assessment, including, for example, how this assessment is made in a master-feeder structure.

Comparison to IFRS

Most of the concepts in this ASU are similar to amendments made to IFRS (see IFRS section of this *Tech Brief* for further discussion of those amendments), and therefore conclusions as to whether an entity is an investment company under US GAAP and IFRS should for the most part be the same. However, the amendments to IFRS were made primarily to provide a scope exception to the consolidation of controlled investees. In contrast, the amendments to US GAAP are for the purpose of clarifying the scope of entities that would apply the specialized investment company accounting and reporting guidance in ASC 946. IFRS does not currently have comprehensive, specialized accounting and reporting guidance for investment companies.

Recent US GAAP Update – Presentation of Financial Statements (Topic 205) *Liquidation Basis of Accounting* (amendments issued through the release of ASU 2013-07)

Status – The amendments in this ASU are effective for entities that determine liquidation is imminent during annual reporting periods beginning after December 15, 2013, and interim reporting periods therein. Entities should apply the requirements prospectively from the day that liquidation becomes imminent. Early adoption is permitted.

The amendments apply to all entities that issue financial statements that are presented in conformity with U.S. GAAP except investment companies that are regulated under the Investment Company Act of 1940 (the 1940 Act).

Summary - The amendments require an entity to prepare its financial statements using the liquidation basis of accounting when liquidation is imminent. Liquidation is imminent when the likelihood is remote that the entity will return from liquidation and either (a) a plan for liquidation is approved by the person or persons with the authority to make such a plan effective and the likelihood is remote that the execution of the plan will be blocked by other parties or (b) a plan for liquidation is being imposed by other forces (for example, involuntary liquidation). If a plan for liquidation was specified in the entity's governing documents from the entity's inception (for example, limited-life entities), the entity should apply the liquidation basis of accounting only if the approved plan for liquidation differs from the plan for liquidation that was specified at the entity's inception.

The entity is also required to accrue and separately present the costs that it expects to incur and the income that it expects to earn (both on an undiscounted basis) during the expected duration of the liquidation, including any costs associated with sale or settlement of those assets and liabilities. The entity shall make such accrual only if and when it has a reasonable basis for estimation.

Additionally, the amendments require disclosures about an entity's plan for liquidation, the methods and significant assumptions used to measure assets and liabilities, the type and amount of costs and income accrued, and the expected duration of the liquidation process.

Impact on investment funds:

Investment funds prepare financial statements that measure assets and most liabilities at fair value, and for the most part, the net recorded amounts might arguably approximate the "the amount of cash or other consideration that an investor might reasonably expect to receive after liquidation" (quotation from the ASU's Basis for Conclusions).

Strict application of the text of the guidance does present a number of practical issues and considerations for investment funds. Some considerations are relatively more straightforward, such as the accrual (and separate presentation) of disposal costs, such as commissions and other settlement fees. Other considerations are perhaps more contentious. For example, to what extent should an investment fund accrue for future management and performance fees, or for expected interest income or other periodic receipts over the liquidation period? Users and preparers of investment fund financial statements should monitor how the investment fund industry implements this guidance in practice. Regardless of the application of the guidance to specific accruals, the ASU provides that such additional accruals should be presented separately, and the methods and assumptions used should be disclosed.

Proposed US GAAP Update – Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent) – an amendment to *Fair Value Measurement* (Topic 820)

Status – Comments on the proposed ASU are due by January 15, 2015

Summary – The amendments in the proposed ASU would remove the requirement to categorize within the fair value hierarchy investments for which fair values are measured at net asset value using the practical expedient. Current US GAAP requires that investments measured at net asset value using the practical expedient in Topic 820 be categorized within the fair value hierarchy using criteria that differ from the criteria used to categorize other fair value measurements within the hierarchy. In addition, under current US GAAP, there is diversity in practice in how investments measured at net asset value with future redemption dates are classified in the hierarchy.

With the removal of such investments from the hierarchy, a reporting entity would continue to disclose information on such investments to help users understand the nature and risks of the investments.

International Financial Reporting Standards (“IFRS”) Update

Recent IFRS Update – *Investment Entities – Amendments to IFRS 10, IFRS 12 and IAS 27*

Status – The amendments are effective for annual periods beginning after January 1, 2014. However, earlier application was permitted. Note that given that the effective date of these amendments is a year later than the effective date of the new consolidation guidance (IFRS 10 *Consolidated Financial Statements)*, which was effective in 2013), many investment funds early adopted these amendments in 2013 to enable the investment fund to be exempted from applying the new consolidation requirements to investee entities which the investment fund is deemed to control.

Summary - The amendments provide for an exemption from consolidation of subsidiaries under IFRS 10 for entities which meet the definition of an 'investment entity', such as certain investment funds. Such entities would instead measure their investment in particular subsidiaries at fair value through profit or loss. The guidance within these issued amendments differs in many respects from the exposure draft issued by the IASB in 2011 (ED 2011/4 *Investment Entities*).

The amendments define an 'investment entity' as an entity that:

- obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;
- commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both, and
- measures and evaluates the performance of substantially all of its investments on a fair value basis.

An entity is required to consider all facts and circumstances when assessing whether it is an investment entity, including its purpose and design. The amendments provide that an investment entity should have the following ‘typical’ characteristics:

- more than one investment
- more than one investor
- investors that are not related to the entity or other members of the group containing the entity
- ownership interests, typically in the form of equity or similar interests (e.g. partnership interests), to which proportionate shares of the net assets of the investment entity are attributed.

If an entity does not meet one or more of these typical characteristics, it is required to justify and disclose how its activities continue to be consistent with that of an investment entity. Additional guidance is provided in determining whether an entity is an investment entity, such as the impacts of being involved in the day-to-day management of an investee or providing investment-related services to third parties, the nature of the entity, and how the entity measures and manages its financial liabilities. The application guidance also includes an example of a typical master-feeder structure, with a conclusion (based on the fact pattern presented) that no feeder funds in such structures would need to consolidate the master fund.

The types of entities which may meet the definition of an investment entity include most investment funds, including mutual funds, private equity and venture capital structures, pension funds and sovereign wealth funds.

Where an entity meets the definition of an investment entity, it is not permitted to consolidate its subsidiaries and is required to measure its investments in those subsidiaries at fair value through profit or loss. However, an investment entity is still required to consolidate a subsidiary where that subsidiary provides services that relate to the investment entity's investment activities.

The amendments also:

- introduce new disclosure requirements related to investment entities in IFRS 12 *Disclosure of Interests in Other Entities* and IAS 27 *Separate Financial Statements;*
- provide a scope exemption for investment entities from IFRS 3 *Business Combinations* (meaning such entities do not need to apply business combination accounting to the acquisition of subsidiaries);
- include various consequential amendments to numerous other standards.

The amendments do not introduce any new accounting requirements for investments in associates or joint ventures. IAS 28 *Investments in Associates and Joint Ventures* already permits an investment fund to measure investments in associates and joint ventures at fair value through profit or loss in accordance with IFRS 9 or IAS 39, and the IASB expects that investment entities would apply these.

Regulatory Update

Regulatory Update – Alternative Investment Fund Managers Directive ("AIFMD") – an update from a Cayman Islands perspective

In our 2013 *Tech Brief* (which can be accessed using the link at the end of this document), we summarized the main provisions of the AIFMD. Below are some further observations to augment our prior year summary.

By way of brief background, the AIFMD provides a European Union framework for the regulation and oversight of alternative investment fund managers ("AIFMs"). The AIFMD and the detailed "Level 2" Regulations were effective July 22, 2013 and the one-year transitional period ended on July 22, 2014. EU AIFMs were required to take all necessary measures to comply on a timely basis and submit an application for authorization as an EU AIFM by July 22, 2014. Since July 2013, non-EU AIFMs have been required to take the necessary measures to comply with the rules of the various national placement regimes ("NPR"), including notifying EU regulators in the member states where they intend to market their funds.

Currently, the NPR is the only marketing and distribution channel available to non-EU AIFMs. Similarly, EU AIFMs intending to market non-EU AIFs in the EU may only do so at the discretion of the regulator of the EU country of distribution, having first submitted the appropriate filings and received the requisite approval. The AIFMD stipulates an overriding requirement for supervisory cooperation arrangements to be in place between the home state regulator of the EU country of distribution and the supervisory authority of the third country where the non-EU AIFM and/or non-EU AIF are established. To this end, the Cayman Islands Monetary Authority ("CIMA") has signed Memoranda of Understanding ("MOUs") with virtually all of the EU member states and the respective cooperation agreements have been or are in the process of being executed.

Cayman Islands investment fund considerations, including closed-ended and other non-registered funds

Under the NPR, the AIFMD permits each member state to introduce rules beyond the AIFMD minimum requirements. Therefore, each member state regulator is able to define its own “gold plating rules” to permit marketing by non-EU AIFMs, or marketing of non-EU AIFs by EU AIFMs, in their jurisdiction. As part of these requirements, many jurisdictions may require a declaration or confirmation that the non-EU AIF is subject to regulation in its home country. Furthermore, the overriding requirement for cooperation agreements to be in place implicitly suggests that the non-EU AIF would need to be subject to regulation in its home jurisdiction; under the regulatory regime of the Cayman Islands, only those funds registered as mutual funds are subject to regulation by CIMA pursuant to the Mutual Funds Law.

Cayman domiciled funds not already registered with CIMA (such as closed-end funds or funds with fewer than 15 investors) may voluntarily register as mutual funds and, therefore, be subject to regulation by CIMA pursuant to the Mutual Funds Law. This might be advisable in two broad scenarios. Firstly, if the governing body of a Cayman domiciled fund determines that the overriding requirement for supervisory co-operation intends the fund to be subject to CIMA regulation, the Fund may opt to voluntarily register to comply with the spirit of the AIFMD with regards to cross border activity. Secondly, in the event that the regulator of the EU member state(s) in which the Cayman fund is marketed explicitly requires the AIF to be regulated in its local jurisdiction, the fund shall register with CIMA to comply with this rule.

The status of each member state’s national legislation is very fluid and AIFMs are urged to consult with their advisors to understand the current state of affairs.

Regulatory Update – Cayman Islands Directors Registration and Licensing Law

The newly enacted Cayman Islands Directors Registration and Licensing Law 2014 requires directors of 1) investment funds regulated under the Cayman Islands Mutual Funds Law and 2) companies registered as “Excluded Persons” under the Cayman Islands Securities Investment Business Law (collectively, “Covered Entities”) to register with, or obtain a license from, CIMA. Note that the law applies not only to professional independent directors, but also to directors who are employees of an investment fund’s investment manager. Further, the law applies to all directors of Covered Entities, regardless of whether the director resides in the Cayman Islands.

There are three categories of regulated directors:

Registered Directors

Directors of less than twenty Covered Entities must register with CIMA, and were required to do so by September 3, 2014. Registered directors pay an annual fee and provide certain prescribed information to CIMA upon initial registration. On an ongoing basis, the director is required to notify CIMA of any changes to the prescribed information.

Professional Directors

Directors of twenty or more Covered Entities were required to obtain a license from CIMA by September 3, 2014 rather than only registering. Certain directors are exempted from obtaining a license (although they still must register). Generally, the exemption is afforded to directors who are affiliated either with an investment manager registered or licensed by a specified overseas regulatory authority or with an entity holding a Cayman Islands Companies Management License or Mutual Funds Administrators License. The specified overseas regulatory authorities are set out in a schedule to the law.

Corporate Directors

Corporate entities acting as directors on Covered Entities must be licensed unless they hold a Mutual Fund Administrators License or a Companies Management License.

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

Background

In our prior *Tech Briefs*, we have discussed the 'Volcker Rule'. By way of background, the so-called 'Volcker Rule' components (colloquially 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' (as defined), will have limits placed on ownership interests in hedge funds and private equity funds, and will be prohibited from sponsoring a hedge fund or private equity fund. 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.

Updated status

The initial intention was for the provisions of these rules to be finalized by July 2012. That initial time period passed without finalization. In December 2013, the provisions were finalized and a final rule issued. At such time, the final rule provided that banking entities generally had until July 21, 2015 to conform their activities and investments to the final rule.

Subsequent to the issuance of the final rule in 2013, based on further comments and requests received by industry participants and other interested parties, the conformance period with respect to 'legacy covered funds' (as defined) was extended to July 21, 2016 (with a very likely further one-year extension forthcoming until July 21, 2017). This extension permits banking entities additional time to divest or conform only legacy covered fund investments and relationships made by banking entities prior to December 31, 2013. All investments and relationships related to investments in a covered fund made after that date must be in conformance by July 21, 2015. It is important to note that the extension does not apply to trading activities, which must conform to the final rule by July 21, 2015.

Regulatory Update – US - Dodd-Frank Act: Confidential Private Fund Risk Reporting Rule and Form PF – an update

In our previous *Tech Briefs*, we described new information reporting required by certain private fund advisers in a new form called 'Form PF.' By way of background, in October 2011, the SEC and the CFTC approved a joint rule, the Confidential Private Fund Risk Reporting rule. This rule, which implements certain sections of the Dodd-Frank Act, requires certain advisers to hedge funds and other private funds to report information for use by the newly established Financial Stability Oversight Council in monitoring risks to the U.S. financial system. The reporting of such information is through a form called Form PF.

The SEC's frequently asked questions on the preparation of Form PF are periodically updated. A number of frequently asked questions have been added in 2014, and can be found at SEC Frequently Asked Questions on Form PF

Fund liquidations – Cayman Islands considerations and alternative solutions

Stakeholders of investment funds domiciled in the Cayman Islands may periodically encounter circumstances where a fund is no longer viable and is discontinuing operations. Typically a fund will realize its investments and redeem its shareholders prior to being placed into voluntary liquidation. Stakeholders may be unfamiliar as to the process, timing and other practical issues relating to a Cayman voluntary liquidation. Various decisions and considerations need to be contemplated by the investment manager, directors, administrator, legal counsel and auditors.

To aid practitioners in understanding the voluntary liquidation process, our Deloitte Cayman Financial Advisory Services group has developed a helpful document *Voluntary liquidation of regulated Cayman Islands Funds – Considerations for all stakeholders.* This document can be found at the following link: 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 document above.

A sidebar - Illiquid asset solutions – realization agent services

Our Financial Advisory ("FA") group within Cayman is continuing to serve funds in run-off in many innovative ways. Typically these engagements involve some form of asset realization mandate for funds with still significant assets that are illiquid or have liquidity restrictions and/or side pockets. Our services are engaged by investment managers and directors, across a diverse range of investment strategies, who wish to avoid liquidating positions in secondary market transactions, recognizing that potentially more value can be driven from a portfolio over time by adopting a low cost run-off strategy. (continued on the next page….)

Our FA group can provide an alternative to the standard liquidation service by acting as a "Realization Manager" or "Agent", typically involving some form of restructuring of the corporate group and setting up a special purpose entity to facilitate an orderly wind down process. In such a structure, our FA group will report to investors, make recommendations as to how and when the underlying investment positions should be realized and relieve the investment managers of the difficulties and risks associated with valuing illiquid positions. Each scenario is reviewed on its own merits and a bespoke, efficient solution can be developed and implemented by the FA group.

This process can keep the investment manager involved via the investment manager becoming a director of the new entity with various controls written into the company's articles. In addition, through the transaction of establishing the special purpose entity, investors may have an opportunity to realize their investment immediately rather than retaining it throughout the duration of the run off period.

Our FA group is involved in the realization of over 100 side pockets, regularly meeting underlying investment managers to monitor and challenge the underlying realization strategies and assumptions, and subsequently undertakes secondary market portfolio and individual position transactions.

Archived editions of *Tech Brief*

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

Tech Brief Volume 1

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

Tech Brief Volume 2

Archive: Volume 3 – December 2010 Technical Brief for Investment Funds

Tech Brief Volume 3

Archive: Volume 4 – December 2011 Technical Brief for Investment Funds

Tech Brief Volume 4

Archive: Volume 5 – December 2012 Technical Brief for Investment Funds

Tech Brief Volume 5

Archive: Volume 6 – December 2013 Technical Brief for Investment Funds

Tech Brief Volume 6

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