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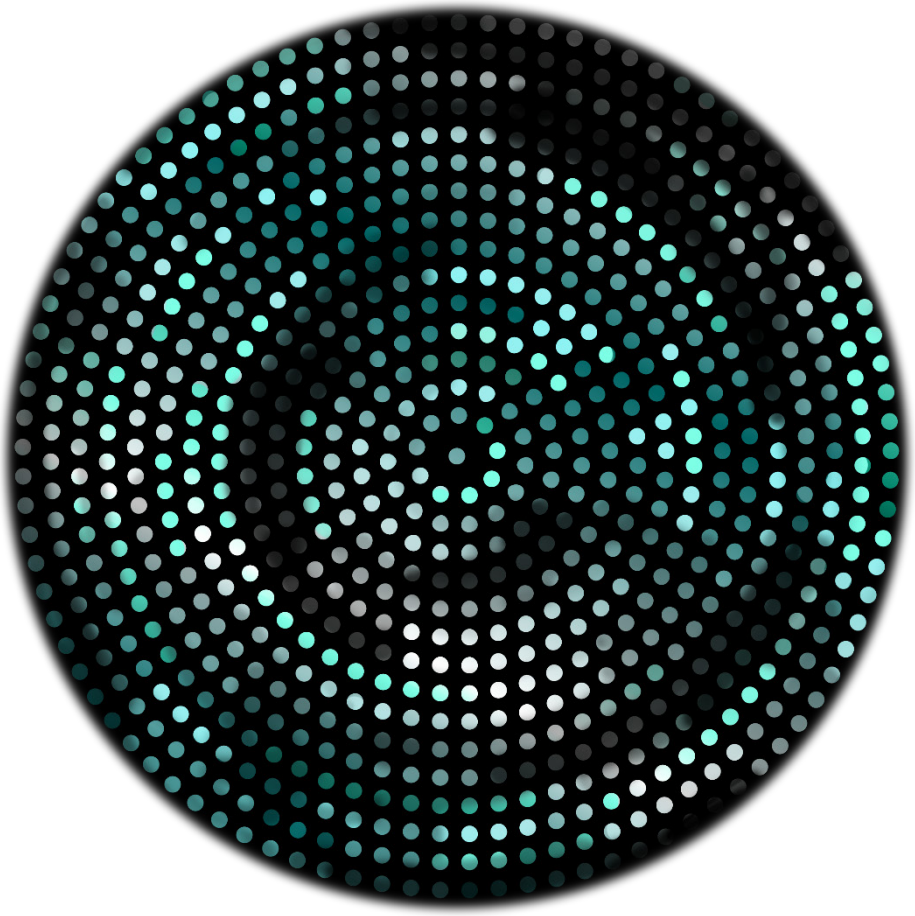
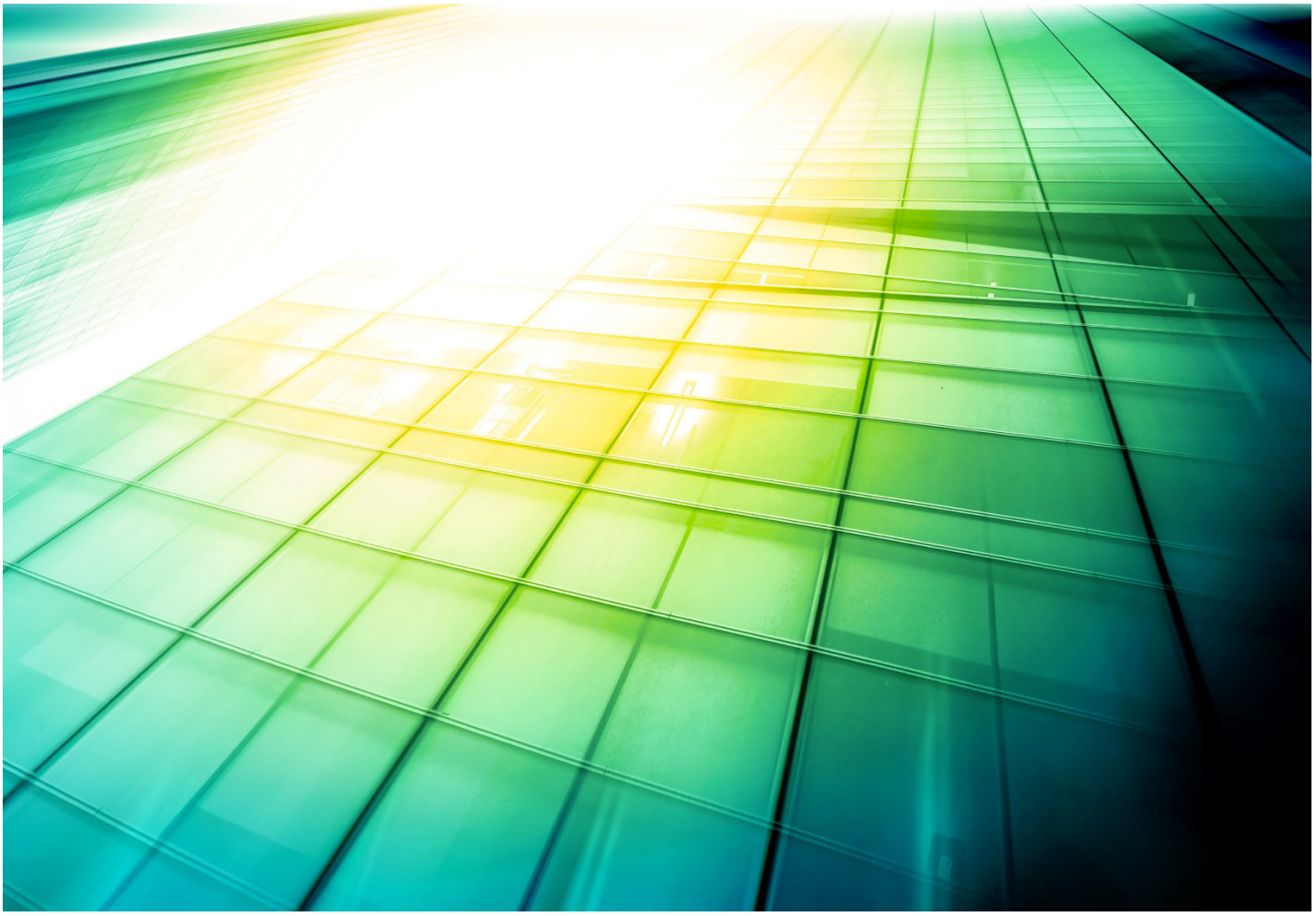


Deloitte in the Cayman Islands - Technical Brief for Investment Funds

Accounting, Auditing and Regulatory

Volume 9 – January 2017

In this issue



Introduction

Welcome to Volume 9 of the *Technical Brief for Investment Funds ("Tech Brief")*, an annual newsletter developed by the Investment Funds Technical Team at Deloitte in the Cayman Islands.

From an accounting and financial reporting standpoint, after several years of more substantial changes, there are only a few updates that will impact investment funds this year. With respect to auditor reporting, the International Auditing and Assurance Standards Board has issued several new or revised auditing standards that significantly change the form and content of the auditor's report for audits conducted in accordance with International Auditing Standards. These changes will potentially introduce a degree of variation in auditor's reports between entities, and stakeholders should become familiar with the changes.

On the regulatory front, there have been some developments that impact the investment management industry. This *Tech Brief* provides brief updates on a few select regulatory matters.

Finally, we summarize some considerations in relation to fund liquidations in the Cayman Islands. We have 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 and have provided an example of the operation of a realization solution.
We have also included a link to a helpful document about wind down considerations and possible solutions in such circumstances.

United States Generally Accepted Accounting Principles ("US GAAP") - Update

Fair Value Measurement (Topic 820) - Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent) (amendments issued through the release of ASU 2015-07)

Status

The amendments in this ASU are effective for public entities for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. For all other entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. A reporting entity should apply the amendments retrospectively to all periods presented. The retrospective approach requires that an investment for which fair value is measured using the net asset value per share practical expedient be removed from the fair value hierarchy in all periods presented in an entity's financial statements. Earlier application is permitted.

Summary

The amendments in this ASU remove the requirement to categorize within the fair value hierarchy investments for which fair values are measured at net asset value (or its equivalent) using the practical expedient. Current US GAAP (prior to this ASU) requires that investments measured at net asset value (or its equivalent) 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.

Under the amendments in this ASU, investments for which fair value is measured at net asset value per share (or its equivalent) using the practical expedient should not be categorized in the fair value hierarchy. Removing those investments from the fair value hierarchy not only eliminates the diversity in practice resulting from the way in which investments measured at net asset value per share (or its equivalent) with future redemption dates are classified, but also ensures that all investments categorized in the fair value hierarchy are classified using a consistent approach. Investments that calculate net asset value per share (or its equivalent), but for which the practical expedient is not applied will continue to be included in the fair value hierarchy.

With the removal of such investments from the hierarchy, a reporting entity should continue to disclose information on such investments to help users understand the nature and risks of the investments and whether the investments, if sold, are probable of being sold at amounts different from net asset value.

International Financial Reporting Standards ("IFRS") - Update

Investment Entities – Applying the Consolidation Exception – Amendments to IFRS 10, IFRS 12 and IAS 28

Status

The amendments require retrospective application and are effective for periods beginning on or after January 1, 2016, with earlier application permitted.

Summary

The International Accounting Standards Board has made some narrow scope amendments to IFRS 10, IFRS 12 and IAS 28 to clarify certain technical issues resulting from previous amendments to the consolidation guidance for investment entities, and investors in and investees of, investment entities. The following are the amendments:

A subsidiary that provides services related to the investment activities of its investment entity parent

In general, IFRS 10 requires an investment entity to measure its investments in subsidiaries at fair value. IFRS 10 provides an exception, however, if a subsidiary provides investment-related services or activities to the investment entity parent. In such a circumstance, that subsidiary is consolidated.

The amendments clarify that this exception applies only to subsidiaries that are not themselves investment entities. If the subsidiary that provides services and activities to the parent is deemed to also be an investment entity, then this exception does not apply and such subsidiary would not be consolidated with the investment entity parent but rather measured at fair value. Such a circumstance would arise when these services and activities of the subsidiary are deemed to be only ancillary to other primary investing activities undertaken by the subsidiary.

Exemption from preparing consolidated financial statements for certain intermediate entities

IFRS 10 provides for a general exemption from preparing consolidated financial statements for a parent whose ultimate or intermediate parent prepares consolidated financial statements that are in accordance with IFRS and publicly available.

The amendments confirm that the exemption from preparing consolidated financial statements continues to be available to a parent entity that is a subsidiary of an investment entity, even if the investment entity measures all of its subsidiaries at fair value in accordance with IFRS 10.

Application of the equity method by a non-investment entity investor to an investment entity investee

In general, when applying the equity method, IAS 28 requires an entity to adjust an associate's or a joint venture's accounting policies if those policies differ from the accounting policies of the entity.

IAS 28 has been amended to allow an entity to retain the fair value measurement applied by an investment entity associate or joint venture to its interest in subsidiaries.

International Standards on Auditing ("ISA") - Update

Amendments to various ISA reporting standards

Status
The amendments are applicable for financial statements for periods ending on or after December 15, 2016.

Summary
In January 2015, the International Auditing and Assurance Standards Board issued a series of new and revised auditor reporting standards. The reporting standards are intended to provide users of the financial statements with more information and transparency into the audit process and the entities that auditors report on. A summary of the revisions to various reporting standards follows.

ISA 700 (Revised) - *Forming an Opinion and Reporting on Financial Statements*

The form and content of the ISA auditor's report has been significantly amended to incorporate new or revised elements. The main changes are as follows:

- Placement of the auditor's opinion, followed by the basis for opinion section, near the beginning of the report to give it greater prominence to the reader of the report;
- Description of responsibilities relating to going concern for both management and the auditor;
- Enhanced reporting requirements when a material uncertainty related to going concern exists;
- Affirmative statement about the auditor's independence and fulfilment of relevant ethical responsibilities;
- Identification of those charged with governance within the management's responsibilities section who are responsible for the oversight of the financial reporting process. In a private fund environment, this would generally be expected to be the directors/trustee/general partner, or for certain fund complexes, the audit committee. Circumstances may vary;
- Revised auditor's reporting on other information included in the annual report of the entity (discussed further below);
- For listed entities, new section to communicate key audit matters (discussed further below); and,
- For listed entities, disclosure of the name of the engagement partner.

ISA 701 (New) – *Communication of Key Audit Matters in the Independent Auditor's Report*

Under this new ISA, an auditor is required to report "key audit matters" in the auditor's report for audits of financial statements for all listed entities. An auditor may also decide to communicate key audit matters for non-listed entities, in which case the provisions of this ISA are applicable.

A "listed entity" is defined within the ISAs as an entity whose equity or debt is quoted or listed on a recognized exchange. In the context of a private investment fund, there is some divergence of views as to whether a fund listed on a non-trading exchange platform solely for visibility, transparency or marketing purposes would be considered a listed entity. We have observed that the more dominant view is that such funds would be considered listed entities as the definition of a listed entity within the ISAs does not explicitly provide any exceptions. In addition, some contend that despite the lack of transferability of such interests on the exchange, investors in such entities have an expectation of greater regulatory oversight by the exchange, and enhanced auditor diligence and transparency that are afforded to listed entities. The counter view to considering such funds as listed entities is that since the fund interests are not actually transferrable on the exchange, and must instead be subscribed and redeemed directly with the fund itself (and meet fund-specific eligibility requirements), the fund doesn't meet the intended spirit of a listed entity.

This ISA is also applicable where the auditor is required by law or regulation to communicate key matters in the auditor's report.

Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements. In practice, matters that an auditor might deem as key for communication in the auditor's report include:

- Significant risks and areas of higher risk of misstatement;
- Areas requiring significant auditor judgments relating to matters in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and
- The effect on the audit of significant events or transactions that occurred during the year.

There is judgment involved on the part of the auditor as to which matters the auditor considers as key for communication to stakeholders within the auditor's report. In addition, the ISA provides only guidelines and examples, rather than strict requirements, as to the content of such communication. Accordingly, stakeholders can expect some variation in practice between auditors, particularly in the first year or two of application.

ISA 720 (Revised) - *The Auditor's Responsibilities Relating to Other Information*

Background - ISA 720 deals with the auditor's responsibilities relating to other information. Other information is financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report. An annual report is a document, or combination of documents prepared typically on an annual basis by management or those charged with governance, the purpose of which is to provide stakeholders with information on the entity's operations, and the entity's financial results and financial position as set out in the financial statements.

Although the auditor's report makes reference to other information, the auditor's opinion on the financial statements does not cover the other information, nor does this ISA require the auditor to obtain audit evidence beyond that required to form an opinion on the financial statements.

The auditor's responsibilities relating to other information apply regardless of whether the other information is obtained by the auditor prior to, or after, the date of the auditor's report.

Revisions - The revisions to ISA 720 aim to clarify and increase the auditor's involvement with other information. The main revisions to ISA 720 are:

- Broadening and clarifying the scope of other information by linking it to the concept of an annual report;
- Enhancing the auditor's work effort with respect to other information; and,
- Providing transparency by requiring reporting on the auditor's work relating to other information.

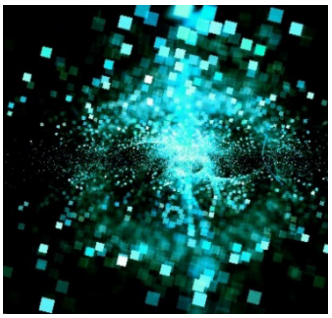
The revised ISA includes examples to show how reporting on other information may be done in various circumstances.

For all entities where the auditor has obtained some or all of the other information as of the date of the auditor's report, the auditor's report will include a separate "other information" section. For listed entities, an "other information" section will also be included if the auditor expects to obtain other information after the date of the auditor's report.

Other ISA reporting amendments – Various amendments have been made to ISA 705– *Modifications to the Opinion in the Independent Auditor's Report* and ISA 706– *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditors Report*, resulting from other amendments to the auditor reporting framework.

Regulatory Update

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



In our prior *Tech Briefs* we summarized the main provisions of the AIFMD. Below are some further developments in 2015 and 2016 that impact Cayman Islands investment funds and investment managers.

Cayman Islands Legislation

In 2015, the Cayman Islands amended its Mutual Funds Law and Securities Investment Business Law to provide an "opt-in" regime for funds and fund managers for compliance with certain existing and future aspects of the AIFMD. The amendments will be of interest to funds and fund managers looking to access European investors, whether through the existing national private placement regimes ("NPPRs") of the respective European countries or the anticipated future use of the AIFMD passport. Although the amendments were made principally to prepare the Cayman Islands for the eventual use of the AIFMD passport, the new Cayman Islands opt-in regime might also be utilized to the extent any European country requires, pursuant to its respective NPPR, regulation of the fund or fund manager in the home jurisdiction of those entities. (We note, however, that even prior to these amendments, a fund manager could have voluntarily registered its fund under the Mutual Funds Law to the extent it needed to do so to comply with certain NPPRs).

The Mutual Funds Law was amended to include a new class of funds called an "EU Connected Fund", which is a fund that is either managed by a manager whose registered office is in an EU member state or is marketed to investors or potential investors in an EU member state. Funds meeting these characteristics that would otherwise not be subject to registration under the Mutual Funds Law (such as closed-end funds) could opt-in and voluntarily register under this new class.

The Securities Investment Business Law was amended to provide for registration of an "EU Connected Manager", which is an investment manager that falls within the existing scope of the Securities Investment Business Law, conducts management, marketing or depositary activities as contemplated under the AIFMD, and voluntarily elects to be subject to Cayman's new EU Connected Manager regime.

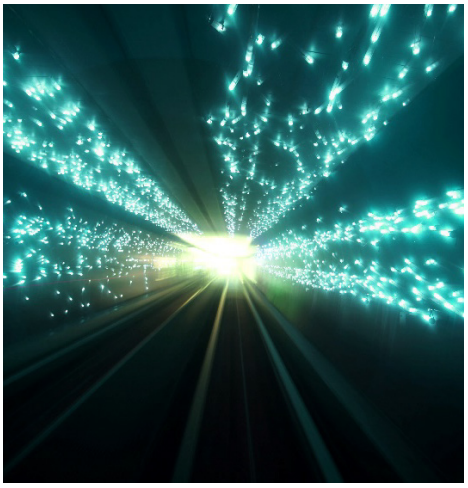
In December 2016, The Mutual Funds (EU Connected Fund (Alternative Investment Managers Directive)) Regulation, 2016 and The Securities Investment Business (EU Connected Fund (Alternative Investment Managers Directive)), 2016 were published. These two new regulations outline the details of regulatory regimes that will be applicable to EU Connected Funds and EU Connected Managers when the regulations come into force. The regulations will require affected funds and fund managers to provide certain initial and ongoing information to the Cayman Islands Monetary Authority ("CIMA"). The funds and fund managers will be required to notify CIMA of any changes to previously submitted information and to provide an annual written confirmation that the cumulative extant information previously submitted has not changed.

Status of the Cayman Islands with respect to the AIFMD

In July 2016, the European Securities and Markets Authority ("ESMA") completed a series of assessments on various non-EEA jurisdictions ("Third Countries"), including the Cayman Islands, as to whether the AIFMD passport would be eventually extended to specific Third Countries. While ESMA generally agreed with the intended regulatory regime for the Cayman Islands, it reserved its final assessment until all legislation and related steps had been implemented. It is anticipated that the legislation enacted in 2015 and 2016 should provide a basis for a final successful assessment, and lead to the extension of an AIFMD passport to the jurisdiction (if and when it is available to Third Countries).

Regulatory Update

US – 'Volcker Rule' – banking entities involvement with investment funds – an update



Background

In our prior Tech Briefs, we have discussed the 'Volcker Rule'. By way of background, the so-called 'Volcker Rule' components of the Dodd-Frank Act (colloquially termed the 'Volcker Rule' after a similar set of rules proposed by Paul Volcker, a former US Federal Reserve Chairman) 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, and then again to July 21, 2017. These successive extensions permitted 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 have been in conformance by July 21, 2015. It is important to note that these extensions did not apply to trading activities, which had to conform to the final rule by July 21, 2015.

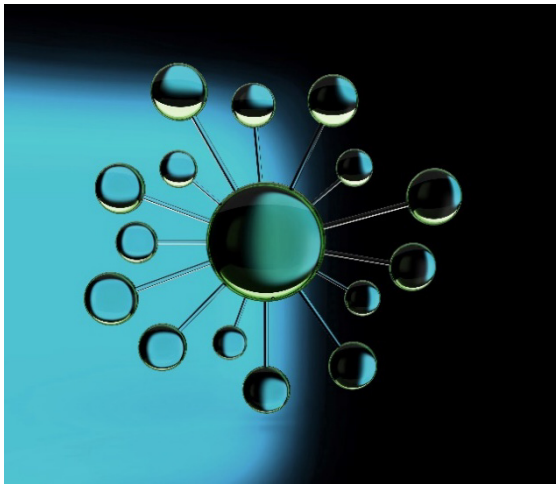
Stakeholders have continued to express concerns about the timing of divesture of illiquid covered funds. In response, on December 9, 2016, the US Federal Reserve Board issued a policy statement regarding the extension of the conformance period for investments in legacy illiquid covered funds. Subject to certain conditions, banking entities may apply for a further five-year extension on or before January 20, 2017 (which is 180 days prior to July 21, 2017). If granted, complete conformity with the Volcker Rule with respect to legacy illiquid covered funds may be extended until July 21, 2022.

Regulatory Update

SEC – auditor independence – financial statement preparation – clarification

Auditors issuing audit reports on the financial statements of SEC registered investment advisors pursuant to the provisions of the SEC's Custody Rule are required to comply with the SEC's auditor independence rule set. Those rules prohibit auditors from performing 'bookkeeping services' for such advisers, including the preparation of financial statements. In 2014, the SEC staff further clarified this prohibition by indicating that auditors should not, among other things, provide typing and word processing services, or financial statement templates that are not publicly available to the audit client as these would be considered prohibited financial statement preparation services. The SEC staff wanted to make clear that these activities are the responsibility of client management. The responsibility of the auditor is solely to express an opinion on those financial statements.

Given this recent focus, both auditors and investment advisers are encouraged to review their policies and procedures as they relate to this SEC prohibition. While any enforcement actions would attach primarily to the auditors, investment advisers would want to avoid the reputational risks associated with their investment funds should an auditor of such funds become the subject of an enforcement.



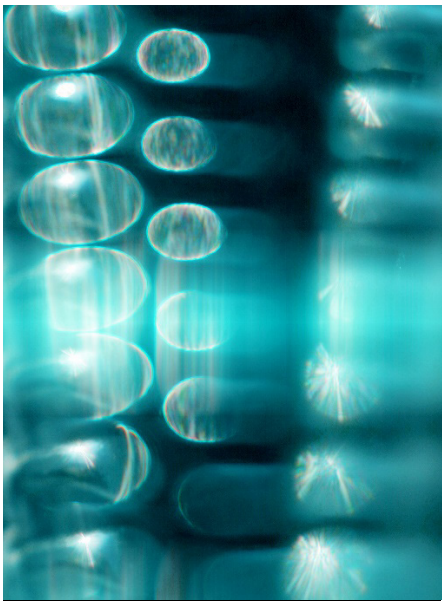
A sidebar – Deloitte in the Cayman Islands – financial reporting solutions for investment funds

Deloitte in the Cayman Islands offers various financial reporting solutions for non-audit clients. As accounting and financial reporting requirements become more complex, many advisers, administrators and fund fiduciaries are seeking to outsource the financial statement preparation function. And for SEC registered advisors, reliance on a fund's auditors to perform even a limited role, from suggesting language on disclosures to processing changes, is prohibited.

If you are seeking assistance with your US GAAP or IFRS investment fund financial statements, whether limited or extensive, we would be happy to have a discussion with you. More information about our financial reporting solutions can be found at the following link: Deloitte in the Cayman Islands - Financial Reporting Solutions

Fund liquidations

Wind down and liquidation considerations – realization 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 investors prior to being placed into voluntary liquidation. However, with some investment funds, final realization of all investments can often be delayed for an extended period. Whether it relates to illiquid investments in fund-of-funds, private debt, private equity, or positions impacted by pending litigation or insolvency proceedings, many entities currently sit in a state of limbo and continue to incur unnecessary service provider costs without an effective strategy or plan for winding down.

Our Financial Advisory team has developed a helpful document about wind down considerations and possible solutions for investment funds encountering such circumstances, which is available for download here: Alternative investment funds - wind down considerations and solutions

A sidebar – Deloitte in the Cayman Islands – realization agent services for investment funds

Our Financial Advisory team specializes in providing fund wind down, liquidation and dispute resolution services to the investment fund industry, acting for stakeholders including hedge fund managers, directors, general partners and investors. We are particularly knowledgeable about the challenges of maximizing realizations from illiquid asset positions and have proven processes and experience to do so.

We have completed an ever increasing volume of soft wind down projects where the fund is no longer trading and the manager's time is now best utilized on new projects. However the fund may still hold valuable but illiquid assets requiring a unique realization strategy or liabilities that cannot be readily extinguished, all of which need to be appropriately managed to maximize value for remaining investors.

Our objective is always the upfront identification and then execution of the right solution in the circumstances in order to achieve maximum value for stakeholders. Should you wish to discuss potential solutions to your fund's unique issues, do not hesitate to contact either Stu Sybersma at ssybersma@deloitte.com or Michael Penner at mpenner@deloitte.com on a no cost and fully confidential basis.

An example – developing and delivering a realization solution

A manager had elected to close operations in order to pursue other endeavors. Our Financial Advisory team at Deloitte in the Cayman islands were engaged as advisors to assist the manager in formulating a restructuring solution for an investment fund structure holding an illiquid fund-of-funds investment portfolio.

The solution included the incorporation of a low cost, fixed-term (3 years) special purpose vehicle ("SPV') with Deloitte engaged as "Realization Manager" to oversee the activities of the SPV and the realization of the investment positions. The investors received an in-kind distribution from the legacy funds for interest in the SPV, which was structured to include six separate share classes to account for six individual portfolios and specific investor interests.

The Realization Manager operated under the oversight of a board of directors, including a director who was a principal at the investment manager of the legacy investment fund structure.

(example continued on next page)

In this role, Deloitte as Realization Manager:

- Facilitated the transfer of over 50 underlying fund-of-funds investment positions to the SPV;
- Undertook an initial auction process, offering investors an immediate liquidity option to realize their holdings in the SPV;
- Calculated quarterly NAVs and issued statements to over 200 capital accounts, and provided dedicated investor support;
- As sufficient cash realizations occurred, calculated and executed periodic distributions to the investors;
- Realized five of the six share class portfolios naturally, and executed a competitive auction process for the sale of the portfolio of the last remaining share class at the conclusion of the SPV term;
- Managed the SPV in accordance with its constitutional documents, and through a transparent and communicative approach with the board of directors of the SPV; and,
- Oversaw distributions to the investors over the life of the SPV.

This solution resulted in a newly formed SPV which reduced annual service provider fees by an estimated 75% and provided a better suited corporate vehicle to oversee the wind down of these funds. The manager still had oversight of the wind down process but without undertaking the administration of a three year run off period.

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