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Cayman Islands
Assurance and Advisory Services

Technical Brief for Investment Funds

Accounting, Financial Reporting and Regulatory

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Introduction

Welcome to Volume 8 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 only a limited number of amendments and refinements to guidance over the past year. 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. 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.

Prior versions of our *Tech Brief* newsletters are available by contacting any of our Investment Funds Technical Team members listed 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 – 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 using the practical expedient. Current US GAAP (prior to this ASU) 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.

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.

Recent US GAAP Update – Transfers and Servicing (Topic 860) *Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures* (amendments issued through the release of ASU 2014-11)

Status – For non-public entities, the accounting changes are effective for annual periods beginning after December 31, 2014. An entity is required to present changes in accounting for transactions outstanding on the effective date as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption.

The disclosure for certain transactions accounted for as a sale, as well as the disclosure for repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowings, are required to be presented for annual periods beginning after December 15, 2014.

Summary – This ASU includes accounting changes and also expands disclosure requirements. It is anticipated that the accounting amendments will affect investment funds to a more limited extent but the disclosure expansions will have a greater impact on investment funds.

Accounting amendments:

1. Entities are required to account for repurchase-to-maturity transactions as secured borrowings (a repurchase-to-maturity transaction is defined within the ASU as a repurchase agreement that settles at the maturity of the transferred financial asset and does not require the transferor to reacquire the transferred financial asset).

2. The elimination of accounting guidance on linked repurchase financing transactions.

Disclosure amendments:

1. Expansion of disclosure requirements for certain transfers (specifically, repurchase agreements, securities lending transactions and repurchase-to-maturity transactions) of financial assets that are accounted for as secured borrowings.

2. Expansion of disclosure requirements related to certain transfers of financial assets that are accounted for as sales.

Overview of accounting amendments

The Financial Accounting Standards Board issued the amendments in response to stakeholders' concerns that existing US GAAP guidance (prior to this ASU) distinguishes between repurchase agreements that settle at the same time as the maturity of the transferred financial asset and those that settle any time before maturity. Specifically, repurchase-to-maturity transactions (defined above) were generally accounted for as sales with forward agreements, whereas typical repurchase agreements that settle before the maturity of the transferred financial asset were accounted for as secured borrowings. As well, existing US GAAP required an evaluation of whether an initial transfer of a financial asset and a contemporaneous repurchase agreement (a repurchase financing) should be accounted for separately or linked. If linked, the arrangement was accounted for on a combined basis as a forward agreement. These outcomes are often referred to as off-balance-sheet accounting.

Many stakeholders contended that there should be no accounting distinctions between different forms of repurchase agreements because in all types of repurchase transactions the transferor retains exposure to the transferred financial assets and obtains important benefits of those assets throughout the term of the transaction. The amendments in this ASU change the accounting for repurchase-to-maturity transactions and linked repurchase financings to secured borrowing accounting, which is consistent with the accounting for other repurchase agreements.

The above is a high-level summary of the accounting changes but affected entities engaging in these types of transactions should refer to the ASU, including its application guidance.

Overview of the disclosure amendments to certain transfers accounted for as secured borrowings

To enhance the transparency of collateral supporting repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions that are accounted for as secured borrowings, the following disclosures are required:

1. A disaggregation of the gross obligation by the class of collateral pledged
2. The remaining contractual tenor of the agreements
3. A discussion of the potential risks associated with the agreements and the related collateral pledged, including obligations arising from a decline in the fair value of the collateral pledged and how those risks are managed

The example below, which is reproduced from the ASU, illustrates how an entity would present information about collateral supporting repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions that are accounted for as secured borrowings.

20XX					
	Remaining Contractual Maturity of the Agreements				
(Dollars in millions)	Overnight and Continuous	Up to 30 Days	30-90 Days	Greater Than 90 Days	Total
Repurchase agreements and repurchase-to-maturity transactions					
U.S. Treasury and agency securities	$ XXX	$ XXX	$ XXX	$ XXX	$ XXX
Asset-backed securities	XXX	XXX	XXX	XXX	XXX
Corporate securities	XXX	XXX	XXX	XXX	XXX
Equity securities	XXX	XXX	XXX	XXX	XXX
Non-U.S. sovereign debt	XXX	XXX	XXX	XXX	XXX
Loans	XXX	XXX	XXX	XXX	XXX
Other	XXX	XXX	XXX	XXX	XXX
Total	XXX	XXX	XXX	XXX	XXX
Securities lending transactions					
U.S. Treasury and agency securities	XXX	XXX	XXX	XXX	XXX
State and municipal securities	XXX	XXX	XXX	XXX	XXX
Corporate securities	XXX	XXX	XXX	XXX	XXX
Equity securities	XXX	XXX	XXX	XXX	XXX
Loans	XXX	XXX	XXX	XXX	XXX
Other	XXX	XXX	XXX	XXX	XXX
Total	XXX	XXX	XXX	XXX	XXX
Total borrowings	**$ XXX**	**$ XXX**	**$ XXX**	**$ XXX**	**$ XXX**
Gross amount of recognized liabilities for repurchase agreements and securities lending in footnote X					**$ XXX**
Amounts related to agreements not included in offsetting disclosure in footnote X					**$ XXX**

Overview of the disclosure amendments to certain transfers accounted for as sales

The amendments in this ASU require disclosures for certain transactions comprising (1) a transfer of a financial asset accounted for as a sale and (2) an agreement with the same transferee entered into in contemplation of the initial transfer that results in the transferor retaining substantially all of the exposure to the economic return on the transferred financial asset throughout the term of the transaction. For those transactions outstanding at the reporting date, the transferor is required to disclose the following by type of transaction (for example, repurchase agreements, securities lending arrangements, and a sale with a total return swap):

1. The carrying amount of assets derecognized as of the date of derecognition
2. The amount of gross proceeds received by the transferor at the time of derecognition for the assets derecognized
3. The information about the transferor's ongoing exposure to the economic return on the transferred financial assets
4. The amounts that are reported in the statement of financial position arising from the transaction, such as those represented by derivative contracts.

The example below, which is reproduced from the ASU, illustrates how an entity would present information about transfers accounted for as sales, such as transactions involving repos, a sale with a total return swap, or securities lending.

	At the Date of Derecognition for Transactions Outstanding		At the Reporting Date		
(Dollars in millions) Type of transaction	Carrying Amount Derecongnized	Gross Cash Proceeds Received for Assets Derecognized	Fair Value of Transferred Assets	Gross Derivative Assets Recorded[(a) (b)]	Gross Derivative Liabilities Recorded[(a) (b)]
Repurchase agreements	$ XX	$ XX	$ XX	$ XX	$ XX
Sale and a total return swap	XX	XX	XX	XX	XX
Securities lending	XX	XX	XX	XX	XX
Total	**$ XX**	**$ XX**	**$ XX**	**$ XX**	**$ XX**

(a) Balances are presented on a gross basis, before the application of counterparty and cash collateral offsetting.
(b) $XX of gross derivative assets and $XX of gross derivative liabilities are included as interest rate contracts in footnote X on derivative disclosures. $XX of gross derivative assets and $XX of gross derivative liabilities are included as credit risk contracts in footnote X on derivative disclosures.

International Financial Reporting Standards ("IFRS") Update

Recent 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.

Regulatory Update

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 that impact Cayman Islands investment funds and investment managers.

Legislation

In 2015, the Cayman Islands amended its Mutual Funds Law and Securities Investment Business Law in order to provide an "opt-in" regime for funds and fund managers for compliance with certain existing and future aspects of the AIFMD. In particular, 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 is 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 is 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.

Status of the Cayman Islands with respect to the AIFMD

In October 2015, Steven Maijoor, Chair of the European Securities and Markets Authority ("ESMA"), indicated to the European Parliament that ESMA would commence assessment of a second group of non-EU jurisdictions and provide a recommendation as to whether the AIFMD passport would be extended to those jurisdictions. The Cayman Islands is included in this second group to be assessed. The timing of the assessment of the Cayman Islands has not been formalized but it is anticipated to be completed in the first half of 2016.

Regulatory Update – Cayman Islands Monetary Authority (“CIMA”) – The Mutual Funds (Annual Returns) (Amendment) Regulations, 2015

On September 15, 2015, the Cayman Islands Government issued certain amended regulations to the Mutual Funds (Annual Returns) Regulations, 2006. By way of background, all regulated under the Cayman Islands’ Mutual Funds Law must submit, to CIMA, within six months of the fund’s financial year-end:

- Audited financial statements; and
- The Fund Annual Return (“FAR”). This is the official form on which fund operators provide general, operating and financial information on the fund. The submission of an annual return is a requirement of the Mutual Funds (Annual Returns) Regulations, 2006.

The Mutual Funds (Annual Returns) (Amendment) Regulations, 2015 (the “Amendments”) were made to allow for certain additional information to be collected and reported in the FAR. Such new information includes, but is not limited to, the following:

- General Information
    - Are there any investors in the master fund that are not regulated feeder funds? If so, how many?
    - If a master fund
        - Name and country of domicile of all feeder funds
        - Name and country of regulator, if applicable
    - Investment Manager
        - Name and country of regulator, if applicable
        - Name and country of sub-advisors or sub-managers
    - Custodian
        - Name and country of custodian contracted
        - Name and country of regulator, if applicable
        - Name and country of any sub-custodians, if applicable
    - Jurisdictions of the investors

- Operating Information
    - Has the fund side-pocketed investments during the reporting period?
    - Has the fund implemented a gate on redemptions or withdrawals during the reporting period?
    - How many operator meetings were held during the reporting period?

- Financial Information
    - Leverage
    - Allocation of equity and debt securities by jurisdiction of issuer

The preparation of the FAR will be more onerous than in previous years. As such, Fund Operators should establish policies and procedures around the collection and reporting of information to be included in the FAR. Fund Operators should begin to aggregate such new data in anticipation of an updated FAR for this upcoming financial reporting cycle. CIMA is currently in the process of updating the FAR and relevant *Guidance Notes and Directions to Completing the Fund Annual Return*. Readers are urged to monitor communications from CIMA and the status of this project closely.

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 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 (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 have been in conformance by July 21, 2015. It is important to note that the extension does not apply to trading activities, which had to conform to the final rule by July 21, 2015.

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 Cayman – financial reporting solutions for investment funds

Deloitte Cayman 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 Cayman - Financial Reporting Solutions**

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 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 Cayman Islands Funds – Considerations for all stakeholders,* which is available on request from Yvonne Lorimer at yvlorimer@deloitte.com, Stu Sybersma at ssybersma@deloitte.com or Mike Penner at mpenner@deloitte.com.

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.

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.

During the last year our FA group has managed the realization of over 130 illiquid assets, 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.

Are you an Emerging Manager?

At Deloitte, we have designed a platform focused on emerging managers and those that provide seed capital. Find out more how we can design a cost effective suite of services that is tailored to the specialized needs of emerging managers. Please contact us to discuss further.

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