



ATTEST **BVS**

Our July newsletter discusses an important topic for many firms: the future of carve-outs. The issue of carve-outs is generating quite a buzz in the investment performance world. The following article will discuss the 2010 guidance regarding carve-outs and how they are to be handled in the future. Also, as always, we will remind everyone of upcoming conferences that we will be attending, and we will congratulate our colleagues for their professional accomplishments.

INSIDE THIS ISSUE

The Carve-Outs of the Future	1	Employee Spotlight	4
BVS Conferences 2008	3	ACA's Fall 2008 Conference	4

The Carve-Outs of the Future

The year 2010 promises to be an eventful year for the GIPS as many new Guidance Statements and requirements will go into effect. Some of these will be relatively easy to integrate into firms' current practices while others will require more effort. One requirement that certainly will prove to be among the most difficult for some firms is the upcoming carve-out requirement that requires firms to maintain cash separately for each carved-out segment.

To avoid alarm, let's first clarify that the use of carve-outs for performance reporting purposes as a general practice will not be prohibited. By that, we mean that the CFA Institute and the GIPS Executive Committee will not require firms to sign multiple contracts with their clients and have multiple custodian accounts. Firms may still choose to run multiple strategies under the same (CONTINUED)





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contract and still maintain an accurate claim of compliance with the GIPS. There is a general notion that carve-outs will disappear in 2010. In reality, only one specific method of maintaining carve-outs will disappear: that of allocating cash to each segment being carved out.

The Guidance Statement that is currently in effect explains in detail what is permissible before 2010 and what is permissible after this date. Prior to 2010, firms must adhere to the following criteria:

- Carve-outs should be managed separately (i.e., the segment should be managed as if it were a separate portfolio, rather than a segment of a larger portfolio).
 - Carve-outs must be representative of a stand-alone portfolio managed to the same strategy.
 - If a firm creates a carve-out of a particular strategy, then all similar portfolio segments managed to that strategy must also be carved-out and included in the composite (e.g., if the equity segment of a balanced portfolio is carved-out and included in an equity composite, then all similar equity segments of the firm's portfolios must be carved-out and included in the equity composite, provided the conditions outlined in this Guidance Statement are met).
 - If a firm chooses to carve-out a portion of a portfolio, they are not compelled to carve-out other parts of the portfolio.
 - When presenting net-of-fees performance of composites containing carve-outs, fees must be deducted from the carved-out returns. The fees must be representative of the fees charged for a separately managed portfolio for the asset class carved out considering the fee schedule for the composite containing the carve-outs.
- The carve-out should have its cash accounted for separately. If the segment does not have its own cash, cash must be allocated to the segment on a consistent basis. Acceptable allocation methods include:
 - *Beginning of Period Allocation.* Identify the cash allocation percentage for each portfolio segment at the beginning of the period. For example, at the beginning of January, identify the percentage of residual cash that will be allocated to the carve-outs at the month end.
 - *Strategic Asset Allocation.* Base the allocation directly upon the target strategic asset allocation. For example, if the portfolio is targeted to have 40% in equities and 60% in bonds, then the allocation will relate to the actual amounts invested.

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- Carve-outs must be managed separately (i.e., the segment must be managed as if it were a separate portfolio, rather than a segment of a larger portfolio).
- The carve-out must have its own cash. Possible methods for properly accounting for the cash positions include:
 - Separate portfolios: cash and securities are actually segregated into a separate portfolio at the custodian.
 - Multiple cash accounts: each segment's cash is accounted for separately (e.g., equity cash account, fixed-income cash account, etc.).
 - Sub-portfolios: each segment of a portfolio is accounted for as if it were a separate portfolio.

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Cash can no longer be allocated to the different segments. Instead, the individual segments must have their own cash balances. What exactly do the new requirements entail? Well, if your firm has an established practice of allocating cash based upon the weighting of the underlying segments, you will have some work to do. Starting in 2010, the cash for each segment must be the actual cash used within the sub-strategy. We would not recommend actually breaking up the master account at the custodian level into multiple accounts. Rather, an easier way to satisfy this requirement will be to set up “sub-accounts” on your portfolio measurement system. This way each of the segments of the overall strategy can be managed with their own cash balance. Whatever path you decide to take, you will want to work in

close conjunction with your verifier and software provider to ensure your actions will result in a compliant structure.

With 2010 rapidly approaching, our recommendation to all firms with carve-outs is to begin the process of integrating the changes we have discussed above. So, what will the carve outs of the future look like? As we have noted, many of them will look exactly like they do today. For a firm already managing the carve-outs with their own cash within the performance software system, things likely will not change. For firms that do not currently maintain cash separately, matters will be more difficult. Either way, now would be a great time to start considering the best way to meet these future requirements.

Beacon Verification Services Conferences 2008

Beacon Verification Services will be exhibiting at the following conferences in 2008. We look forward to seeing you there!

Advent Software
8–10 September 2008
Bellagio Hotel
Las Vegas, Nevada

GIPS Standards Annual Conference
25–26 September 2008
Westin Copley Place
Boston, Massachusetts

Schwab IMPACT® Conference
23–26 September 2008
Georgia World Center
Atlanta, Georgia

Congratulations!

We would like to offer our warmest congratulations to Alicia Hyde, Kamelia Dari, and Coley McKinstry for achieving the CIPM (Certificate in Investment Performance Measurement) designation.

We at Beacon are strong supporters of the CIPM program. The designation involves a demanding pair of tests which is excellent preparation for the everyday challenges we face as verifiers.



Employee Spotlight: Austin Jabaley



Austin Jabaley is a verification associate serving our client base with the initial and on-going verification of GIPS compliance.

Prior to joining ACA, Austin graduated from The University of Tennessee at Chattanooga with a B.S. in Finance. He completed an internship with Wachovia Securities in which he was responsible for portfolio valuations and security recommendations pertaining to clients' investment strategies.

Austin also completed an internship with Contemporary Healthcare Capital, LLC, a mezzanine fund aimed toward long term care facilities. Austin participated in preparing underwriting reports for potential loans as well as financial statement analysis to ensure compliance with loan covenants.

Austin is a member of the CFA Institute and the Chattanooga Society of Financial Analysts. He will be taking the CIPM examination in the coming months.

ACA's Fall 2008 Compliance Conference

Join ACA Compliance Group and *IM Insight* at their compliance conference geared towards investment advisers and hedge fund managers. The conference will be held September 8-10 in Boston, MA. Knowledgeable speakers will provide valuable information on timely issues present in the securities industry.



Topics Include:

- Anti-Money Laundering Provisions to Advisers
- New Form ADV Part II
- Valuation
- Trading & Trade Errors
- Best Execution
- Privacy and Regulation S-P
- How to Manage an SEC Inspection
- Advisers to Mutual Funds: How to Comply with Investment Company Act Rule 38a-1
- GIPS Workshop
- Identifying Prohibited Transactions for Mutual Funds
- Workshop, Peer Group, and More!

To learn more, please visit:

www.acacompliancegroup.com/conference08