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Why C-Level Executives Should Be Concerned About the New Cost Basis Reporting Rules

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Executive Summary

What Is It?

As part of the Emergency Economic Stabilization Act of 2008, H.R. 1424, (the Act, Pub. L. No. 110-343), signed by President George W. Bush in October of 2008, Title IV, Section 403 requires the reporting of adjusted cost basis information for covered securities to the Internal Revenue Service (IRS) and to taxpayers. The initial effective date for cost basis reporting for most stocks applies to stock acquired on or after January 1, 2011; for mutual funds and dividend reinvestment plan stock (or similar arrangements) acquired on or after January 1, 2012; and for debt instruments, options, and other covered securities acquired on or after January 1, 2013. The provision is scored by the US Treasury to raise \$6.67 billion over a ten year period, due to the systemic over-reporting of cost basis and thus underreporting of actual tax liabilities.

Why Is it Important?

Although the initial effective date may seem distant, preparation to handle the technology, operational, tax, legal, and business issues associated with compliance is likely to be very cumbersome for many firms, with brokers in particular needing to be acutely aware of the requirements. Besides these issues, failure to provide the IRS and taxpayers with correct cost basis reporting information could subject brokers to significant tax penalty risk. As a result, we strongly advise that brokerages aggressively seek a solution to be tested and live by the end of 2010 before trading begins in January 2011.

Our call for urgency is based on a detailed survey of 175 responses conducted over the summer of 2009 with leaders in the financial services sector, including C-Suite executives, VPs, directors, managers, and line staff at broker-dealers, investment advisors, mutual funds, banks, asset managers/hedge funds, and custodians. According to our survey, although the industry overall is aware of and concerned about the requirements of this law, it is quite weak in actual preparedness.

What Needs to Be Done?

Active research and preparation is taking place, particularly at firms (such as broker-dealers and mutual fund companies) and business areas (such as tax and operations) and by people in the roles most affected by this law, with tax personnel the most acutely aware of the obligations and requirements to be placed on them.

However, overall concern seems inappropriately low, given the scope of the new requirements and the needed implementations and modifications of technology systems and operations. While some are taking the necessary planning steps, others are planning to depend upon service providers for compliance, such as vendors and clearing firms. Still others have yet to allocate budgets and many do not have any implementation plans in place.

“We believe that the brokerage industry has wholly underestimated the amount of time necessary to implement cost basis reporting solutions and that C-level executives must begin spurring staff to do more.”

Therefore, we believe that the industry has wholly underestimated the amount of time necessary to implement cost basis reporting solutions and that C-level executives must begin spurring staff to do more. This lack of urgency is likely due in part to complacency at firms and a history of successful ongoing relationships with trusted technology vendors and clearing firms who are promising delivery of a solution going forward. Moreover, while guidance on specific aspects of the law is expected shortly, firms must begin putting together a solution and not wait for the picture to be 100% clear before moving ahead.

What Is the Industry Already Doing?

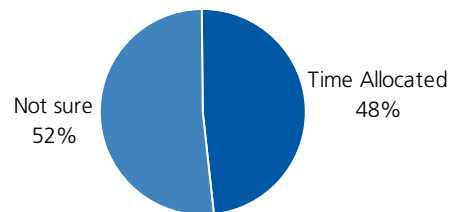
As seen in Figure 1 on page 5, over half of the survey respondents who will need to implement a solution or else rely on a partner relationship for a solution are unaware whether time has actually been allocated for this process. This is troublesome, since the compliance process will include a multitude of time-consuming steps starting with a buy versus build analysis, vendor evaluations, developing project specifications, procurement, development, implementation, testing and go live—all before the January 1, 2011 initial effective date.

There are perhaps some explanations for the current lack of urgency. Some survey participants may view this as another party's issue while others may believe that the IRS or other government body will make

the deadlines a moving target. Since this is a statutory law put into effect via an act of Congress, changing the timelines would require an additional act of Congress, which is highly unlikely. Particularly in this economic climate, we believe lawmakers and regulators do not have the patience for delays, especially with laws that have implications for federal tax revenue collection.

Figure 1: It's about time: cost basis reporting compliance—48% have allocated time, 52% aren't sure

Firms that have allocated time to prepare and implement a solution for cost basis reporting requirements



Source: Celent in conjunction with Wolters Kluwer Financial Services

What Should I Do?

It is time for action from C-level executives. To reach ultimate compliance, executives should begin directing their teams to develop requirements and roadmaps and/or reached out to trusted vendors very soon. If firms wait until the last minute (and by last minute, we mean beginning in December 2009 for some firms), even trusted vendors may be too busy or unresponsive, while internal developers and operational teams may be overwhelmed with the coding and testing necessary to ensure compliance. As executives should be keenly aware, failure to meet compliance smoothly and on time could have strong ramifications for internal operations and even business prospects, as well as relations with regulators, including fiscal penalties.

Our Research Process

In the spring and summer of 2009, a survey was conducted by Celent (a member of the Oliver Wyman Group) in conjunction with Wolters Kluwer Financial Services to determine awareness and preparedness for the cost basis reporting law in order to assess where the industry stands and where it needs to go. The high response rate to this survey underscores the activity and interest level of this law in the brokerage and broader financial services community. We collected 175 detailed survey responses across a wide array of stakeholders, including broker-dealers, investment advisors, mutual fund companies, banks, asset managers, hedge funds, custodians, clearing firms, and other involved market participants. The size of the firms surveyed as measured by assets under management or advisement ranged from more than US\$15 billion to less than US\$1 billion. Additionally, our respondent base spanned a multitude of functions including general management (9%), compliance (13%), operations (29%), portfolio management (7%), tax (25%), and IT/legal/risk management (10%), among others (7%). Furthermore, the opinion of a mosaic of roles and responsibilities was probed, ranging from C-Suite executives (11%) to VPs (25%), directors (11%), managers (32%), and line staff or other (21%) to reflect multiple perspectives on the new requirements.

The New Law

A study in 2001 of individual tax returns showed that almost 40% incorrectly reported gains and losses from sales of stock and other securities. Of those mistakes, some 50% were due to mistakes in computing tax basis of stocks and securities sold. The US treasury estimated that closing this tax gap would result in US\$6.67 billion in additional tax revenues. As a result, as part of the Emergency Economic Stabilization Act of 2008, H.R. 1424, (the Act, Pub. L. No. 110-343) signed by President George W. Bush in October of 2008, Title IV, Section 403 requires the reporting of adjusted cost basis information for covered securities to the Internal Revenue Service (IRS) and to taxpayers. The new law applies to stock acquired on or after January 1, 2011; to open-end mutual fund and dividend reinvestment plan stock acquired on or after January 1, 2012; and to debt instruments, options, and other covered securities acquired on or after January 1, 2013.

While basis reporting will make tax preparation simpler for individuals, it will require additional work by form 1099-B preparers and brokerage firms. In addition, the IRS will be able to verify that the basis information in tax returns matches the 1099-B's it receives.

Due to the complexities related to cost basis reporting, firms are tasked with the daunting responsibility of implementing a sophisticated system to meet these new requirements. Although many organizations have some type of cost basis system in place, the new law creates additional complexities in terms of the following: wash sales, transfer of cost basis when a client switches brokerage firms, and allocation and identification of tax lots and sub-lots. For example, not all firms have an adequate methodology for determining lots, or for allowing a client to specify lots or a default lot relief choice.

Time Is of the Essence

Our survey results provide the most robust and detailed analysis of current thinking around the new cost basis reporting law to date. We take a detailed look at awareness, preparation, and compliance planning with a critical lens unseen thus far in the industry. In addition, we provide readers with a view on next steps and a look at the current composition of vendor solutions.

With extensive data in hand from our active respondents, a number of key conclusions became immediately apparent. We believe that the industry must do more, and that executives must spur their staffs to work with a greater sense of urgency to meet compliance in the time allotted, which is really the end of 2010 if firms expect to be compliant when trading begins in January 2011.

In order to see the foundation and analysis underpinning this key conclusion, we have organized our paper into the following components and concepts:

- Awareness of the cost basis reporting law and concern over requirements
- Planning and preparation for compliance with the cost basis reporting law
- A Call to Action: The need for urgency to plan/implement a solution to comply with this law

Awareness/Concern Levels Are Elevated, But Not Sufficient

Overall

Of the firms responding to our survey, most were aware of the new law and have elevated levels of concern over the need to start planning for compliance. In particular, large funds and broker-dealers are highly concerned with the new rules. We also found that from a functional/role perspective, tax departments and line staff are uniquely aware of and concerned about the new law. In operations departments, we often found that line staff and specialists with daily responsibilities most affected by new rules were the individuals most likely to be concerned about how their roles will change and what new demands will be placed on them. Awareness and concern levels seem reasonable for compliance with a simple new law with a timeline for sometime next year. But basis reporting is not so simple. As a result, we question whether the overall concern levels of 58% reflect the expected difficulty of actual compliance.

“We question whether the overall concern levels of 58% reflect the expected difficulty of actual compliance.”

We found that particular areas of concern over compliance with new rules include appropriateness of underlying technology systems, the allotted timeframes for compliance, and the complexity of the requirements. As readers may know, the new rules go beyond basic client reporting and instead are a complicated set of calculations, such as basis method elections and lot averaging. In addition, brokerage firms can expect a high volume of inbound inquiries around tax season as to how calculations were made and sent to the IRS.

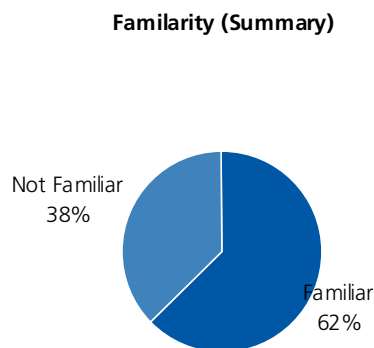
Levels of awareness and concern varied along functional levels. Most individuals were rightly concerned by how the new rules would affect their jobs or portfolios. For example, tax personnel are most concerned with wash sales, while compliance staff are concerned about basis method elections and reconciliations. At the same time, portfolio managers are concerned about corporate actions adjustments and whether the calculated basis will actually match their own views.

The remainder of this section gives a detailed overview of the survey results in addition to these overall themes.

Awareness Levels

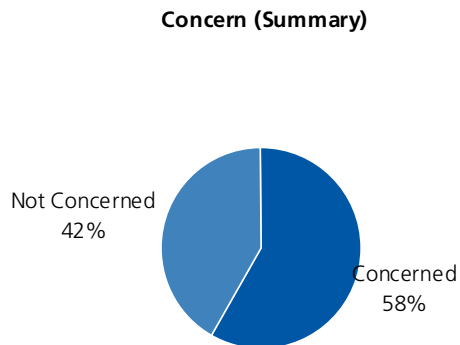
We measured overall awareness based on both basic familiarity and levels of concern over the new cost basis reporting rules. As indicated in Figure 2, we note that almost two-thirds (62%) of the respondents are familiar with the new laws, and as seen in Figure 3 on page 11 concern over compliance is at similar levels (58%). While we believe a response rate at or near 60% reflects a reasonably healthy awareness and concern over compliance with the new law, we are not convinced it is an adequate level in this situation, given the steps that need to be taken to reach compliance for basis reporting.

Figure 2: Familiarity levels are inadequate for the steps required to reach compliance



Source: Celent in conjunction with Wolters Kluwer Financial Services

Figure 3: Concern levels are inadequate for the steps required to reach compliance

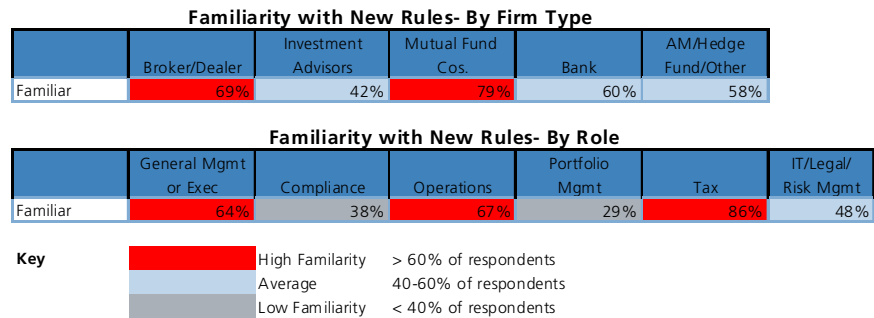


Source: Celent in conjunction with Wolters Kluwer Financial Services

At the same time, awareness and concern differs significantly by firm type, reflecting the ultimate burden of compliance. Foreshadowing the future, Figure 4 on page 12 shows that respondents at broker-dealers (69%) and mutual fund companies (79%) are more aware of the new rules than banks (60%) and investment advisors (42%). Also, as seen in Figure 5 on page 12, broker-dealers are rightly concerned, as the burden of basis calculations and reporting will fall on them, as well as the added burden of transfer reporting. However, cost basis reporting requirements could also fall on parties who are in a position to know the cost of securities and are in the operations value chain, even if they currently have no 1099-B reporting obligation.

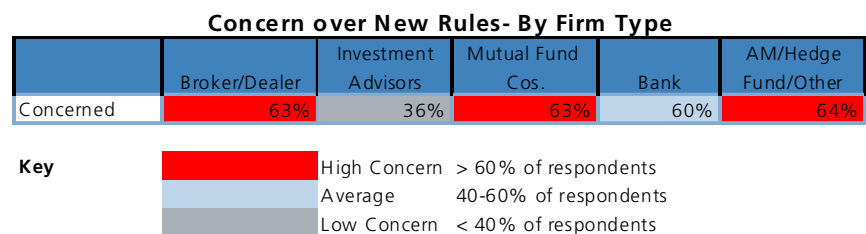
Moreover, mutual fund companies, along with even custodians, might ultimately be classified under a broader definition of applicable persons for transfer reporting. We suspect the IRS will issue guidance on this matter. Finally, the lack of concern among respondents at investment advisors is a consistent theme of the survey and underscores the dependence by investment advisors on relationships with clearing-houses and custodians for services and eventual compliance with basis reporting obligations.

Figure 4: Familiarity with new rules by respondent type



Source: Celent in conjunction with Wolters Kluwer Financial Services

Figure 5: Concern over new rules by respondent type



Source: Celent in conjunction with Wolters Kluwer Financial Services

While basis reporting must ultimately be complied with by law, it is not solely a compliance issue, nor is it simply monitoring and reporting basic information. Basis reporting will involve designing, building, testing, maintaining, and working with intricate technology systems, which will involve operations and IT people heavily. At the same time, dedicated tax teams will need to manage complicated topics such as wash sale rules and lot elections. Thus, as seen in Figure 6 on page 13, and Figure 7 on page 14, not surprisingly concern differs even more significantly by roles and responsibilities at firms surveyed, with operations (63%) and tax personnel (74%) much more likely to be concerned with the new laws than portfolio management or compliance personnel. (We use a response rate at or above the 60% threshold as a key indicator.) At the same time, firms with a higher level of assets under management or advisement are almost two times as likely to be

aware and concerned over the new laws. This is also not surprising because these firms have more to lose and may have their own complicated legacy systems to contend with soon.

Figure 6: Types of concern over new rules by role

Concern over New Rules- By Role						
	General Mgmt or Exec	Compliance	Operations	Portfolio Mgmt	Tax	IT/Legal/ Risk Mgmt
Concerned	59%	41%	63%	35%	74%	43%

Key		High Concern	> 60% of respondents
		Average	40-60% of respondents
		Low Concern	< 40% of respondents

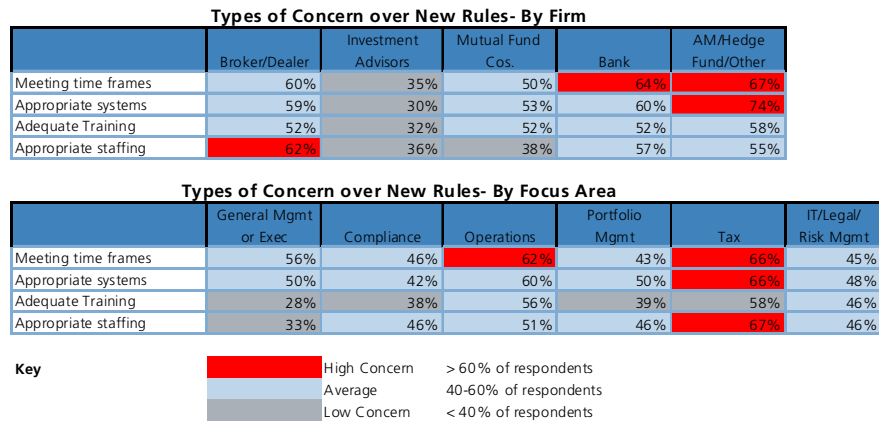
Source: Celent in conjunction with Wolters Kluwer Financial Services

With limited resources and budgets and a looming deadline, concern over compliance is centered on having proper systems in place and meeting regulatory timeframes, with operations and tax personnel being most concerned about these aspects.

“Concern over compliance is centered on having proper systems in place and meeting regulatory timeframes.”

To achieve compliance, other key inputs such as staffing levels and training are secondary concerns at this point, with the exception of broker-dealers, who will be significantly burdened and may need to allocate significant nontechnology resources. For example, the inbound inquiries related to tax lot choice options, transfer requests, and especially explanations regarding how basis calculations were arrived at could overwhelm call center support at brokerage firms.

Figure 7: Types of concern over new rules by firm and focus area



Source: Celent in conjunction with Wolters Kluwer Financial Services

“VP-level and Director-level personnel are the most concerned about reaching compliance.”

As seen in Figure 8 on page 15, from a responsibility standpoint, VP-level and Director-level personnel are the most concerned about reaching compliance with the new rules. We think this makes sense because C-Level executives will place the responsibility for compliance with the new laws upon senior team members, as compliance will depend on cobbling together planning teams, assigning budgets, managing the RFP process, and choosing a vendor or else assigning internal staff to IT development, assigning project managers, getting feedback, and above all else adhering to the allotted timeframe. For some VPs and Directors, failure to meet these deadlines could create career risk, because penalties for noncompliance could be severe.

Figure 8: Types of concern over new rules by level of responsibility

Types of Concern over New Rules- By Level of Responsibility						
	C-Suite	EVP/SVP/VP	Director	Manager	Line Staff	Board
Meeting time frames	53%	68%	64%	56%	49%	48%
Appropriate systems	37%	63%	59%	58%	57%	50%
Adequate Training	37%	57%	41%	50%	54%	48%
Appropriate staffing	37%	66%	64%	51%	46%	43%

Key		High Concern	> 60% of respondents
		Average	40-60% of respondents
		Low Concern	< 40% of respondents

Source: Celent in conjunction with Wolters Kluwer Financial Services

Detailed Aspects of the Law

Before becoming compliant, of course, firms must immerse themselves in the detailed aspects of the law. Cost basis reporting is not simple arithmetic; it covers a mosaic of complicated issues, including applicability, basis method elections, reconciliation with customer reporting, numerous special rules and mechanical issues, transfer reporting, issuer reporting, and broker practices and procedures. For the edification of the reader, each of these aspects is defined in the glossary at the end of the report. However, each aspect has complications. For example, basis method elections includes the requirement that customers are actively informed of the default basis determination, while the brokers are themselves notified of a customer's election (and whether and how often a customer might make a change). In addition, depending on IRS guidance forthcoming, brokers may be required to support all tax lot relief methods allowed by the IRS (including FIFO and specific identification, single and double category averaging for mutual funds, and DRIPs).

Moreover, reconciliation with customer reporting could be a hot button. Broker reporting on 1099-B and customer reporting on tax forms must be as consistent as possible, while allowing for the fact that brokers are not required to adjust for "separate account" wash sales, but taxpayers must do so. How far will the tax forms deviate from the 1099-Bs? As we have already mentioned, explaining the cost basis calculation to customers may be more than a two minute phone conversation. Other issues such as complexities associated with wash sales and the ultimate transfer reporting requirements add to the above complexities.

“Broker-dealers and mutual fund companies show high concern levels over just about every component of the new law.”

Looking into each of the aspects of the law from a firm perspective, as seen in Figure 9, broker-dealers and mutual fund companies show high concern levels over just about every component of the new regulations. Using the threshold of 60% as an indicator, broker-dealers have concern with five out of six aspects, and mutual funds are concerned with all six. Which ultimately raises the question addressed by the following section: how exactly will these firms ultimately plan, prepare for, and reach compliance?

Figure 9: Concern over various aspects of new rules by firm type

Concern over Various Aspects of New Rules- By Firm					
	Broker/Dealer	Investment Advisors	Mutual Fund Cos.	Bank	AM/Hedge Fund/Other
Basis method elections	53%	50%	71%	49%	58%
Recon. w/ customer reporting	62%	47%	63%	52%	58%
Special rules/mechanical issues	75%	47%	71%	39%	60%
Transfer reporting	69%	47%	68%	56%	48%
Issuer reporting	69%	47%	63%	53%	55%
Broker practices/procedures	68%	47%	63%	52%	55%

Key

	High Concern > 60% of respondents
	Average 40-60% of respondents
	Low Concern < 40% of respondents

Source: Celent in conjunction with Wolters Kluwer Financial Services

Industry Planning/Preparation for Compliance: Under Way, But Slow Going

Timeframe Is Short

While we feel the level of planning and preparation for cost basis reporting compliance is reasonable for a simple regulation, we believe it reflects over-optimism about the amount of time necessary to implement a solution for cost basis. The new law requires compliance by January 2011, which in essence requires an ideal timeline such as the following:

Ideal Compliance Timeline

- Summer 2009/ Fall 2009: End of research and beginning of compliance planning process
- Decision: buy, build, or combination?
- Development of solution plan and timeline
- Winter 2009: Vendor selection and proof of concept
- Spring 2010: Solution development and implementation
- Summer 2010: Complete implementation, testing/ compliance
- Fall 2010 / Winter 2010: Final testing/compliance/go live
- Spring 2011: Ongoing compliance

As a result, we believe C-level executives reading this report must move their staff beyond the research phase into the decision phase, which will require an honest assessment of internal resources to meet the new requirements or else look for an external partner.

Preparation Is Varied

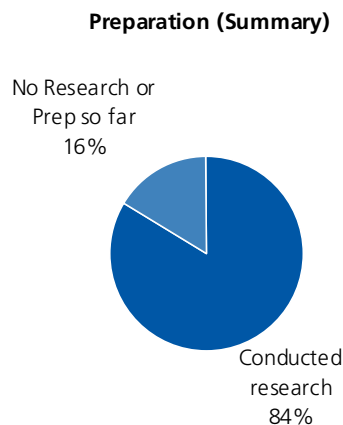
We define preparation for compliance with cost basis reporting as the attendance of a conference or webinar, reading an industry white paper, and other methods of research. Today, according to our survey, by firm types and by role, broker-dealers, mutual funds, and operations and tax personnel are doing the most to prepare for compliance, which is synchronized with our own view of where the ultimate responsibility falls for development of a solution. In terms of implementation, while many firms are unsure of their next steps, there are some clear expectations that trusted vendors and/or key clearing partners will be relied

on to fulfill requirements, rather than heavily drawing upon internal resources. However, what is not clear is how far along these vendors or partners are with a solution. We discuss an aggregate view of vendor options later in this paper.

“By firm types and by role, broker-dealers, mutual funds, and operations and tax personnel are doing the most to prepare for compliance.”

As seen in Figure 10, 84% of respondents have conducted some type of research or attended a conference to become more educated.

Figure 10: Preparation levels at respondent firms



Source: Celent in conjunction with Wolters Kluwer Financial Services

At the same time, according to Figure 11 on page 19, respondents at broker-dealers, mutual funds, and banks are the most likely to have conducted research on the new cost basis law, with favoritism shown to webinars and white papers as methods to do so at low cost, reflecting economic conditions and technology advances.

Figure 11: Preparation for new rules by firm type

Preparation for New Rules- By Firm

	Broker/ Dealer	Investment Advisors	Mutual Fund Cos.	Bank	AM/Hedge Fund/Other
Attended a conference	37%	5%	48%	31%	33%
Attended a webinar	67%	39%	77%	79%	71%
Read an industry white paper	64%	44%	81%	64%	67%
Conducted other research	51%	15%	45%	45%	38%
None of these	19%	22%	10%	10%	17%

Key

	Freq. prep	> 60% of respondents
	Average	40-60% of respondents
	Unfreq. prep	< 40% of respondents

Source: Celent in conjunction with Wolters Kluwer Financial Services
 Note- respondents selected all applicable preparation methods

Not surprisingly, as seen in Figure 12, preparation varies among organizational roles. Operations and tax personnel are preparing the most for compliance, and are two times as likely as other roles to have conducted certain types of research on the new cost basis law. In addition, general management shows a high amount of research preparation efforts around the new rules.

Figure 12: Preparation for new rules by firm role

Preparation for New Rules- By Role

	General Mgmt or Exec	Compliance	Operations	Portfolio Mgmt	Tax	IT/Legal/ Risk Mgmt
Attended a conference	28%	10%	30%	14%	56%	18%
Attended a webinar	67%	31%	81%	7%	86%	55%
Read an industry white paper	72%	41%	66%	21%	88%	46%
Conducted other research	67%	28%	42%	0%	64%	18%
None of these	11%	38%	4%	57%	2%	34%

Key

	Freq. prep	> 60% of respondents
	Average	40-60% of respondents
	Unfreq. prep	< 40% of respondents

Source: Celent in conjunction with Wolters Kluwer Financial Services
 Note- respondents selected all applicable preparation methods

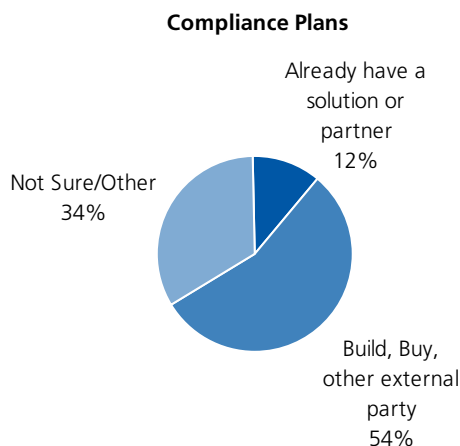
Compliance Plans Are Varied

Although 84% of respondents have conducted some type of research or attended a conference to become more educated, the industry lags in actually implementing a solution. As we have demonstrated, the firms will have to do more than just research. They will have to work toward

a goal over a series of steps. Since we have estimated that the compliance process might take up to 12–18 months, but probably 9–12 months at a minimum, industry progress on implementation is something we might expect to be taking place already.

As illustrated in Figure 13, our survey reports some limited progress on the actual decision-making: 54% plan to buy/build or use an external partner, while 12% claim to have a solution in place. However, an alarming 34% are not sure of their approach at this point and must make a decision in the next few months, in our view.

Figure 13: Compliance plans vary considerably and reflect uncertainty



Source: Celent in conjunction with Wolters Kluwer Financial Services

Although many are unsure of plans, some limited themes are emerging, as seen in Figure 14 on page 21. As of today, 26% of broker-dealers will employ a third party to build or help build a system, while 14% will build a solution internally. Banks prefer a combination of building and buying (24%) and asset managers/hedge funds expect to build their own systems (25%). However, this is where the limited industry progress tapers off. While investment advisors can be expected to rely upon clearing platforms (37%), mutual fund companies lack a real consensus on next steps.

Figure 14: Compliance methods vary by firm type

Compliance Planning- By Firm Type

	Broker/Dealer	Investment Advisors	Mutual Fund Cos.	Bank	AM/Hedge Fund/Other
Build system	14%	3%	3%	3%	25%
Buy system from third party	4%	3%	3%	12%	11%
Combination building and buying	22%	9%	10%	24%	8%
Clearinghouse to manage	17%	37%	20%	6%	0%
Already have a solution in place	10%	11%	17%	12%	3%
Not sure	26%	29%	30%	35%	33%
Other	8%	9%	17%	9%	19%

Key

- Commonly identified strategy ? 20% of respondents
- Strategy identified only on ave: 10-20% of respondents
- Uncommonly identified strategy < 10% of respondents

Source: Celent in conjunction with Wolters Kluwer Financial Services

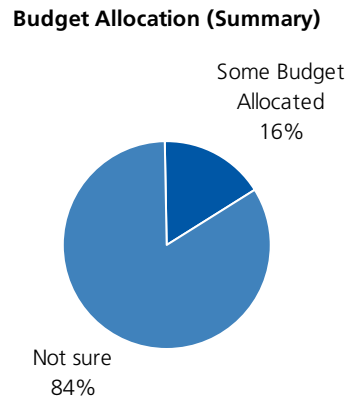
“We have misgivings about the overall lack of planning across the respondent firms.”

In summary, we have misgivings about the overall lack of planning across the respondent firms. In addition, our threshold of 20% as a commonly identified strategy to deduce a trend may artificially overstate the actual consensus behind these decisions.

Allocations of Time and Budget: Lack of Substance

At the same time, a large number of participants were unable, unwilling, or relying on others to formulate budgets for meeting the requirements through either a build or buy scenario (only 16% have any budget allocated at all, as seen in Figure 15 on page 22). The lack of urgency and the expense of creating or buying a solution may create a difficult environment for firms facing the need for ultimate compliance. However, from our perspective, time is a much more important consideration than budget.

Figure 15: Limited budgets have been allocated for compliance

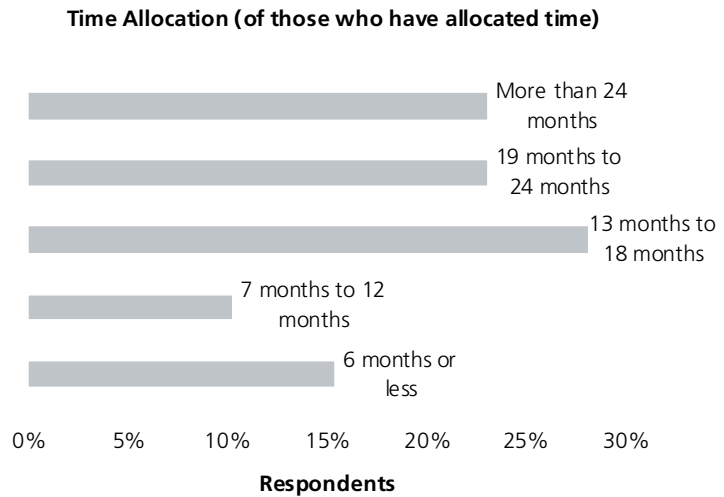


Source: Celent in conjunction with Wolters Kluwer Financial Services

In the summer of 2009, as demonstrated in Figure 16 on page 23, 75% of those respondents that have allocated time view it as an exercise that will take at least 13 months to implement a solution. While this could include some of the larger brokerage firms with longer implementation cycles, it nonetheless reflects the complexity of the process and is an alarming trend for the industry.

“75% of those respondents that have allocated time view it as an exercise that will take at least 13 months to implement a solution.”

Figure 16: Consensus of over 13 months to implement a solution



Source: Celent in conjunction with Wolters Kluwer Financial Services

System Preferences: Handling Complexity Is Crucial

Compliance with the law will depend largely on improved technology systems at broker-dealers. While market participants are rightly concerned about the cost of buying or building a new system (or enhancing an old one), the features of systems most broadly believed by surveyed firms to be important are concentrated around the complex nature of the requirements. These requirements are clustered around the handling of widely held equities positions, with an emphasis on supporting a variety of lot release methods, accurate wash sale adjustments, and accurate corporate actions adjustments. To gauge the importance of system features, we used a cutoff of 85% of responses to determine if a system feature was important. A higher than usual threshold was used to reflect that respondents were given a wish list and not told what the assumed cost of these features might be.

According to Figure 17 on page 24, broker-dealers had a high propensity to rate different system features highly overall, as did mutual funds. Support for short sales, options, and fixed income was low, which reflects the near-term emphasis of the regulations on basis reporting for equities transactions.

Figure 17: Importance of system features selected by firms

Importance of System Feature Preferences- By Firm

	Broker/Dealer	Investment Advisors	Mutual Fund Cos.	Bank	AM/Hedge Fund/Other
Accurate wash sale adjustments	91%	75%	96%	78%	64%
Accurate corporate actions adjustments	93%	95%	91%	85%	79%
Support for variety of lot release methods	91%	75%	91%	85%	71%
Support bifurcation of accounts	83%	83%	91%	81%	82%
Support fixed income instruments	81%	80%	55%	84%	63%
Track cost basis for short sales	85%	65%	64%	75%	64%
Track cost basis for options	83%	56%	48%	75%	69%
Cost of the system	91%	100%	100%	85%	79%

Key

	Important	> 85% of respondents
	Average	60-85% of respondents
	Not Important	< 60% of respondents

Source: Celent in conjunction with Wolters Kluwer Financial Services
 Note- respondents selected all relevant features

By role, strong preferences are shown for varied aspects of systems and at an elevated level overall. Tax, operations, and compliance personnel show particular concern for features such as wash sale adjustments, corporate actions adjustments, support for a variety of lot release methods, and bifurcation of accounts. Support for fixed income, short sales, and options rank much lower than core aspects and can be considered “noncore” at the moment.

Figure 18: Importance of system features selected by focus area

Importance of System Feature Preferences- By Focus Area

	General Mgmt or Exec	Compliance	Operations	Portfolio Mgmt	Tax	IT/Legal/ Risk Mgmt
Accurate wash sale adjustments	92%	91%	83%	80%	94%	56%
Accurate corporate actions adjustments	92%	90%	90%	100%	98%	64%
Support for variety of lot release methods	75%	91%	85%	100%	91%	68%
Support bifurcation of accounts	75%	90%	83%	80%	91%	71%
Support fixed income instruments	46%	78%	75%	90%	84%	61%
Track cost basis for short sales	73%	67%	72%	70%	87%	58%
Track cost basis for options	50%	63%	74%	60%	82%	57%
Cost of the system	92%	91%	94%	70%	98%	76%

Key

	Important	> 85% of respondents
	Average	60-85% of respondents
	Not Important	< 60% of respondents

Source: Celent in conjunction with Wolters Kluwer Financial Services
 Note- respondents selected all relevant features

A Call to Action: Industry Implementation and the Lack of Urgency

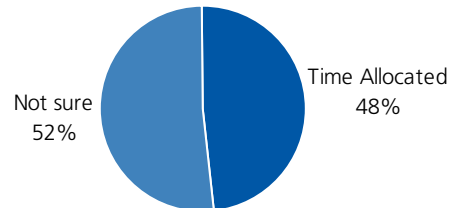
From an industry perspective, as outside watchers we are concerned about progress so far, and believe that the industry has wholly underestimated the amount of time necessary to implement solutions and reach compliance. We believe this could be due to a bit of complacency, combined with a history of successful ongoing relationships with trusted technology vendors and clearing firms to meet past requirements, since those will be the firms depended upon for compliance going forward.

“We are concerned about progress so far, and believe that the industry has wholly underestimated the amount of time necessary to implement solutions and reach compliance.”

Our industry call to action arises from the fact that 48% of affected respondents have allocated some time to meet the new requirements, while a whopping 52% are not sure, reflecting over-optimism about the amount of time to deliver a solution, as highlighted in Figure 19 on page 26.

Figure 19: It's about time: cost basis reporting compliance—48% have allocated time, 52% aren't sure

Firms that have allocated time to prepare and implement a solution for cost basis reporting requirements



Source: Celent in conjunction with Wolters Kluwer Financial Services

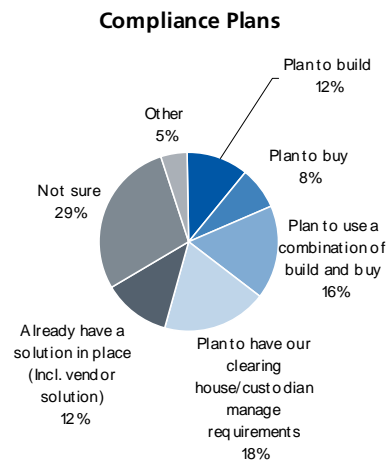
Actual compliance can include a multitude of time-consuming steps, and these participants may view this as someone else's issue and lack a real sense of urgency. In addition, some participants may believe that government bodies will make the deadlines a moving target, but we are not so sure that this is likely. In this heightened regulatory climate, we believe regulators will not have the stomach for delays, especially since the new laws have implications for federal tax revenue collection.

It is time for action to follow the research and preparation done so far. To reach ultimate compliance, executives, business managers, and operational/tax/legal staff should have already begun directing their teams to reach out to vendors or started to formulate internal requirements. If firms wait until the last minute (and by last minute, we mean fewer than 12 months prior in some cases), even trusted vendors may be too busy or unresponsive, while internal developers and operational teams may be overwhelmed with the coding and testing necessary to ensure compliance. As executives are keenly aware, failure to implement smoothly and on time can have strong ramifications for internal operations as well as with external clients and regulators.

Next Steps for Executives: Seeking Outside Vendor Assistance?

Compliance with basis reporting law will entail a series of decisions and organizational steps. Some firms will develop internal solutions, while others will rely on partners, depending on the organization role in the securities operations chain. A detailed look into aggregate compliance plans from our respondents is provided in Figure 20. According to our survey, 12% of the total believes they already have a solution vendor in place, while 8% plan to buy, and 16% plan to use a combination of build and buy. Thus, 36% of the total will either depend on an existing vendor or look for an outside vendor relationship.

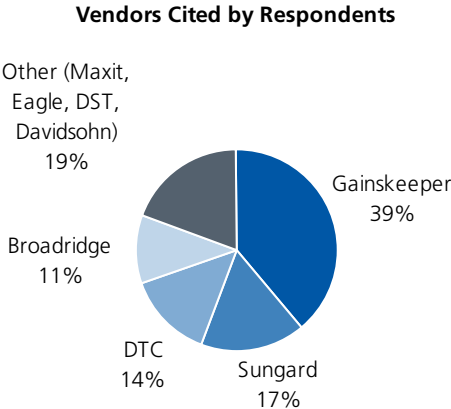
Figure 20: Compliance plans are quite varied



Source: Celent in conjunction with Wolters Kluwer Financial Services

We asked respondents to tell us which possible vendors come to mind to assist the firms in complying with the new costs basis reporting rules. As shown in Figure 21 on page 28, at 39% of respondents, GainKeeper (Wolters Kluwer, CCH, and Capital Changes) was the most cited vendor followed by SunGard 17%, DTC 14%, Broadridge 11%, while others cited included Maxit (SciVantage), Eagle, DST, and Davidsohn, for example.

Figure 21: Compliance plans and vendor recognition



Source: Celent in conjunction with Wolters Kluwer Financial Services

Conclusion

Progress toward cost basis reporting compliance is not progressing as it should, given the timeline of the new law. We believe that more firms must move beyond research into actual planning and development, whether through internal resources or through partnerships with technology vendors and other key providers. The nature of the new law and the potential for penalties for noncompliance mean a lack of progress can lead to some undesirable outcomes.

For instance, failure to provide the IRS and taxpayers with correct cost basis reporting information could subject brokers to significant tax penalty risk. The penalty for an error is essentially \$100 per incorrect Form 1099 (a \$50 penalty for providing the IRS an incorrect Form 1099 and another \$50 penalty for providing the taxpayer with an incorrect Form 1099), subject to a current maximum on the broker for all failures during the calendar year of \$350,000 (\$250,000 on the returns provided to the IRS and \$100,000 on the returns provided to taxpayers). In the case of an error that is due to intentional disregard, the aggregate penalty is the greater of \$200 or 10% of the amount required to be reported correctly per return, without any maximum limitation.

With the penalties for noncompliance as well as the important business considerations, C-level executives will be responsible for increasing the amount of attention and the all-important urgency factor to comply with the cost basis reporting law beginning in January 2011.

Glossary of IRS Public Commentary Topics

On February 6, 2009 the Internal Revenue Service (IRS) invited public comments on 36 issues under eight categories as it formulates guidance for the cost basis reporting law. In this report, we have referenced many of these aspects, which are noted below to assist the reader with understanding some of the complex issues and terminology associated with this law:

1. Applicability of reporting requirements. Who are the applicable parties under a broad definition of a broker, which may include mutual funds and custodians? Those supplying 1099-B gross proceeds reporting already will be obliged.
2. Basis method elections. How to ensure that customers are adequately informed of the broker's default basis determination method and that brokers are adequately notified of a customer's election of a different method.
3. Dividend reinvestment plans. The expansion of average cost basis as a method beyond mutual fund shares to include dividend reinvestment plan (DRIP) stock. Coding both ordinary stock and DRIP shares.
4. Reconciliation with customer reporting. How to ensure that broker reporting on Form 1099-B and customer reporting on Schedule D Form 1040 are maximally consistent.
5. Special rules and mechanical issues. (1) The scope of the wash sale exception, the definition of identical securities, the wash sale period. (2) How to apply rules for basis reporting of options; impact on short sales and/or on securities purchased with foreign currency.
6. Transfer reporting. (1) What information should be included. (2) Considerations around the 15-day required reporting period. (3) Applicability to partial transfers.
7. Issuer reporting. (1) What information should be included. (2) Considerations around maximizing timely issuance of statements. (3) Coordinating broker transfer reporting with issuer corporate action reporting.
8. Broker practices and procedures. (1) Extent of broker responsibility for verification of reasonableness of basis. (2) Applicable documents. (3) Procedures for failure to provide the documents.

Firm Profiles

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