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Cost-basis reporting mandate: Prepare now or pay later

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Broker-dealers, banks, transfer agents and other financial intermediaries will soon be required to report accurate cost-basis information under a new law to help the IRS combat an estimated \$11 billion in annual capital gains underreporting. Investors have always been required to provide basis information themselves, but until now, financial intermediaries only had to report the actual proceeds from a sale. Beginning in 2011, broker-dealers and other financial intermediaries will be required to track and report not only cost-basis information, but also the adjusted cost basis of any security that is sold. Compliance will be a huge undertaking. Broker-dealers who do not conduct proper due diligence risk hefty fines if their reporting proves to be inaccurate. From project management and tax issues to systems integration and data integrity, broker-dealers need to prepare now to navigate the numerous challenges of compliance.

What does the mandate require?

Startlingly few firms are aware of the IRS cost-basis reporting mandate that will require broker-dealers to report customers' cost-basis information beginning in 2011. This mandate was included in the Emergency Economic Stabilization Act of 2008 as a means to generate tax revenue and enhance transparency for investors. The mandate requires adjusted cost-basis reporting for:

- stock transactions posted on or after Jan. 1, 2011;
- mutual funds and dividend reinvestment plans on or after Jan. 1, 2012; and
- financial instruments, such as debt securities and options, on or after Jan. 1, 2013.

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Given these seemingly distant dates, broker-dealers may be lulled into postponing preparations for compliance. Yet with the burden of accuracy now resting mainly on their shoulders, many broker-dealers must overhaul their approach to cost-basis reporting. They must realize that the process of tracking and capturing cost-basis information can be tedious, time-consuming and expensive.

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Cost-basis reporting mandate: Prepare now or pay later (continued)

Broker-dealers must juggle an array of issues under the new mandate, including the following.

Issue	Treatment under the new mandate
1099B requirement	Adjust the cost basis and include the holding term on Form 1099B for: <ul style="list-style-type: none">• stock in a corporation;• securities eligible for average cost, such as mutual funds and dividend reinvestment plans (DRiPs); and• all other securities as prescribed by the Treasury.
Tax-lot accounting	FIFO is the default approach for equities; average cost basis is to be used for DRiPs and mutual funds. However, customers can still choose a specific ID methodology. Reporting is done on an account by account basis.
Wash sales	The cost basis must be reported on wash sales, but only for transactions in the same account and for identical securities with the same CUSIP number.
Short sales	Must report in the year the sale is covered, rather than the current practice of reporting in the year the sale is opened.
Options	Proceeds must be reported beginning in 2013.
S corporations	Must be treated as a partnership for tax reporting purposes.
Interim transfers	Track and capture cost-basis information when a customer moves an account to another firm.
Mutual funds	Broker-dealers may combine or split average-cost calculations for pre- and post-effective dates.
DRiPs	DRiPs are generally reported as if they are open-ended mutual funds. Issuers must report cost-basis implications on corporate actions.
Issuer reporting	Issuers must report cost-basis implications on corporate actions.

What's next?

A key area the IRS needs to address is to what extent a broker-dealer should be required to verify the reasonableness of basis information. Industry representatives have suggested that broker-dealers should be required to verify only the information captured through trade activity that they process for their own books, but should not be responsible for validating the reasonableness of information received from a transferor or issuer. Similarly, members of the industry have requested clarification to assure that clearing broker-dealers will not be penalized for inaccurate basis information provided to them by another broker-dealer or a non-broker transferor. Without this guidance, broker-dealers will likely need to invest additional resources to verify the reasonableness of basis information.

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Challenges

Broker-dealers face a number of challenges implementing the mandate. Although some guidance is expected from the IRS in the future, broker-dealers need to prepare to answer some key questions, including:

- What securities are subject to the mandate?
- What form should be used?
- What happens in the case of grandfathered holdings?
- How will the tax cost basis for separate accounts held by the same broker-dealer for a single taxpayer be calculated?
- How can broker-dealers provide necessary tax information in the case of a transfer of customer accounts?
- How should corporate actions without a clear tax opinion be treated? How should corporate actions be treated for non-U.S. companies that do not provide U.S. tax opinions?
- Are broker-dealers forced to apply the wash-sale rules and adjust the cost basis and holding period? How should mutual funds be treated?
- Should broker-dealers begin implementation now, even without IRS guidance?



Cost-basis reporting mandate: Prepare now or pay later (continued)

In addition, tracking and capturing this information will be a major undertaking for broker-dealers. The tracking and reporting requirements may touch upon several operational areas and could require enhancements to various systems applications, reporting programs and operational procedures. Many firms may find that they do not have the resources to manage the cost-basis mandate process themselves. At the very least, an initial impact assessment will be necessary to determine what applications and processes may need to be enhanced for the firm to comply with the new rules. Once this assessment has been completed, a project team should be organized to assign tasks and track progress. An internal or external project management office (PMO) can help plan, standardize and execute the cost-basis compliance process and ensure that it is delivered on time and within budget. A PMO can also help broker-dealers stay up to date on new legislative developments and any best practices that emerge, especially from industry comments on IRS Notice 2009-17, *Information Reporting of Customer's Basis in Securities Transactions*.

Data integrity will also be a huge component of compliance. Unfortunately, many broker-dealers are ill-equipped to track and capture necessary cost-basis information. They will be charged with updating tax-lot accounting systems as well as client interfaces. An assessment of data sources that are feeding the tax reporting process should be initiated so that the data can be verified and/or corrected. Firms should not underestimate these efforts, which include confirming the accuracy of the data across the entire transaction cycle.

Although guidance from the IRS is pending, compliance with this mandate will require ample time and resources. The cost of getting the compliance process wrong will ultimately outweigh the initial investment in getting it right. The sooner broker-dealers begin preparing, the better. •



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Are you ready for OSI?

Developed by the Options Clearing Corporation and a committee of industry professionals, the Options Symbology Initiative (OSI) is a plan to overhaul the existing method of identifying exchange-listed options contracts. OSI affects any firm that trades or uses information related to exchange-traded options. Trading, settlements and other operational systems associated with processing and clearing options trades will be impacted. Most of the work required by the exchanges and major vendors has been completed. Now it's up to the broker-dealers to assess the impact, make modifications and conduct testing.

This multi-year effort is expected to conclude in 2010.

- **September 2009 to January 2010:** Scripted industry testing of the new environment under OSI pre- and post-symbol conversion scenarios.
- **Feb. 12, 2010:** Mandatory cutover for use of the OSI data elements by all market participants.
- **February to May 2010:** Conversion of all current symbols into their base symbols.

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Benefits

Having the right approach and tools are essential to ensuring a seamless transition to OSI with minimal impact to business and operations. In fact, OSI will result in numerous benefits for broker-dealers, exchanges, vendors and clearing firms, including:

- fewer processing errors;
- greater consistency through utilization of the same symbol as the underlying security for the majority of listed options contracts;
- reduction of corporate action symbol conversions;
- elimination of wrap symbols;
- elimination of the need for the Long-term Equity Anticipation Securities (LEAPS®) rollover process; and
- reduced need for interfacing among exchanges for symbol elections.

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Next steps

Firms should perform a readiness assessment, make required changes to OSI-impacted systems, and conduct testing before the planned cutover and conversion dates to avoid any operational interruptions and compliance issues. •



What you need to know about derivatives reform legislation

As part of efforts to reform the U.S. financial system, the Obama administration has proposed legislation that would bring the over-the-counter (OTC) derivatives market, including credit-default swaps (CDS), under federal regulation. The draft bill would require the clearing of OTC derivatives and would also institute capital and margin requirements for broker-dealers. As the proposed legislation evolves, broker-dealers need to be aware of its scope and unanswered questions.

Who will regulate CDS?

Although the bill proposes to split regulatory duties between the SEC and the Commodity Futures Trading Commission, it remains to be seen which agency will monitor CDS, adding further complexity to implementation and compliance.

How are CDS defined?

For accounting purposes, CDS are classified as derivatives and not insurance contracts, and are subject to the FASB *Accounting Standards Codification*TM 815, *Derivatives and Hedging*, (formerly FASB Statement 133, *Accounting for Derivative Instruments and Hedging Activities*). Under the rule, CDS are carried at fair value.

The legislation needs to determine whether CDS will be considered derivatives or insurance contracts for regulatory purposes — it is not clear if state insurance regulators could claim oversight of these products. •

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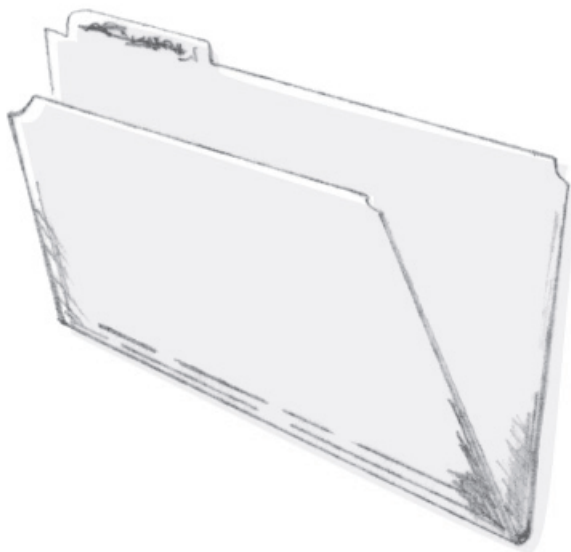
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Push for SEC assessment of customer assets may change FOCUS reports

Custody of assets is one of the latest issues to receive the SEC's attention as calls for reform continue to ring out. The Capital Markets Steering Committee of the Securities Industry and Financial Markets Association (SIFMA) is drafting a response to the SEC's request for more information to assist in the assessment of a broker-dealer customers' business. This information would include a questionnaire on the nature of the customer's business and more importantly, an appendix in the broker-dealer's Form X-17A-5 (FOCUS report) with a schedule that would list the approximate values and locations of customer assets held in custody.

Currently, the value of a customer's fully paid assets is not included in the financial statements of broker-dealers. Such assets are reflected by quantity only in the stock record of the broker-dealer and released only on a memorandum basis. Under the proposed changes, assets belonging to customers would be carved out and reported separately in an amendment to the FOCUS report. Should this type of reporting become required, auditors and broker-dealers both must be prepared for additional work validating prices and reconciling the settlement-date stock record to the trade-date customer position. Broker-dealers should be alert to the development of SIFMA's response and provide input to regulators to address concerns. •



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