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14 October 2009

Cost Basis Reporting Compliance CALL TO ACTION: An Industry Under-Prepared Wolters Kluwer Financial Services & Celent's David Easthope

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Welcome

- Hostess Kathy Iverson
- Polling Questions
- Bios

David L. Easthope, Senior Analyst, Celent



- David Easthope is a senior analyst in Celent's securities and investments practice and is based in the firm's San Francisco office.
- He is a Chartered Financial Analyst (CFA) and member of the San Francisco Security Analysts Society. Mr. Easthope's expertise lies in securities trading and post-trade systems and broker-dealer strategic initiatives. In addition to cost basis reporting, he has written widely on topics relevant to broker dealers in the post-trade landscape such as STP at brokerage firms, European post-trade processing, and a series of reports on corporate actions automation.
- Mr. Easthope has been widely quoted in the press, including the *Financial Times*, Bloomberg, Reuters, and CNBC.

Charles Ross, General Manager, GainsKeeper



- With more than 20 years experience in the financial services industry, Charles Ross is currently general manager of GainsKeeper.
- Previously he was general manager of Wolters Kluwer Financial Services' Insurance Compliance Services & director of Business Development. He also served as vice president at Morgan Stanley and as a senior consultant at Monitor Company, a global consulting and merchant-banking firm.
- A member, Boston Security Analysts Society, Chuck earned his M.B.A. at the Wharton School, and his B.A. from Bowdoin College.

Stevie D. Conlon, Tax Director, GainsKeeper



- Cost basis reporting thought leader and tax director with GainsKeeper®, Stevie D. Conlon authored Wolters Kluwer Financial Services' comments on IRS Notice 2009-17, its comments to the Senate Finance Committee staff on an earlier version of cost basis reporting, as well as numerous articles on the law.
- She is a former Chair of the American Bar Association Tax Section Financial Transactions Committee, a former Tax Section Council Director, former Chair of the Chicago Bar Association Federal Taxation Committee and a Fellow of the American College of Tax Counsel. An author of a tax law treatise and over 35 tax articles. She was previously a tax partner in national law firms, is a member of the New York and Illinois Bars, and is a Certified Public Accountant (CPA).
- She earned her J.D., cum laude, and her Bachelor of Business Administration (B.B.A), public accounting, summa cum laude from Loyola University of Chicago.

Introduction

- As part of our ongoing commitment to cost basis reporting law thought leadership, Wolters Kluwer Financial Services wanted to take the industry's compliance preparedness 'pulse'
- Honored to partner with Celent for this important industry survey and resulting paper *Why C-Level Executives Should be Concerned about the New Cost Basis Reporting Rules*
- Results provide a "call for action"

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

David Easthope, CFA
Senior Analyst, Celent



Agenda

1. Background

2. Results: Where Does the Industry Stand on Cost Basis Reporting?

- Heat maps: Awareness and Concern
- Heat maps: System preferences

3. Results: Progress So Far

- Heat maps: Planning and Preparation
- What is the Industry Already Doing?
- What Should the Industry Do?

4. A Call to Action: Next Steps for Executives

- Industry implementation and the lack of urgency
- An Ideal timeline
- Compliance plans and vendor recognition

5. Conclusions



Background

Cost Basis Reporting: background details and summary

What is It?	Why is It Important?	What Needs to be Done?
<ul style="list-style-type: none"> ▪ Part of the Emergency Economic Stabilization Act of 2008, H.R. 1424 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 ▪ Initial effective date for stocks applies to stock acquired on or after January 1, 2011 ▪ For mutual funds and dividend reinvestment plan stock acquired on or after January 1, 2012 ▪ For debt instruments, options, and other covered securities acquired on or after January 1, 2013 	<ul style="list-style-type: none"> ▪ Although the initial effective date may seem distant, preparation to handle the issues associated with compliance is likely to be very cumbersome for many firms ▪ Compliance Issues will cover: <ul style="list-style-type: none"> - technology - operations - tax - legal - Customer touch points ▪ Brokers in particular need to be acutely aware of and plan for compliance ▪ Failure to provide the IRS and taxpayers with correct cost basis reporting information could subject brokers to tax penalty risk 	<ul style="list-style-type: none"> ▪ While IRS guidance is expected, firms must begin putting together a solution and not wait for the picture to be 100% clear before moving ahead. ▪ Steps toward a solution: a multitude of time-consuming steps starting with: <ul style="list-style-type: none"> - buy versus build analysis - vendor evaluations (if applicable) - developing project specifications - procurement - development - implementation, testing and go live—all before the January 1, 2011 initial effective date

A wide reaching act covering an array of financial products and deeply impacting financial firms across a wide number of areas— and with a near-term deadline of January 1, 2011 (for equities)

Celent Survey in Conjunction with Wolters Kluwer Financial Services

Survey research process and results

Survey design

- In the spring and summer of 2009, a survey was conducted by Celent in conjunction with Wolters Kluwer Financial Services to determine:
 - awareness and preparedness for the cost basis reporting law
 - where the industry stands and where it needs to go
- We collected 175 complete and detailed survey responses across a wide array of stakeholders, including:
 - broker-dealers (39%)
 - investment advisors (18%)
 - banks (16%)
 - mutual fund companies (12%)
 - custodians/clearing firms/fund services (9%)
 - asset managers/hedge funds (2%)
 - other involved market participants (4%)
- Goal: A high response rate, underscoring the activity and interest level of this law in the brokerage and broader financial services community

Survey results

- A deep respondent base spanning a multitude of functions:
 - general management (9%)
 - compliance (13%)
 - operations (29%)
 - portfolio management (7%)
 - tax (25%)
 - IT/legal/risk management (10%)
 - others (7%)
- The opinion of a mosaic of roles and responsibilities:
 - C-Suite executives (11%)
 - VPs (25%)
 - directors (11%)
 - managers (32%)
 - line staff or other (21%)
- Reaching the influencers: 63% of our respondents have a role in the purchase decision of new compliance products or services
- A broad survey of firms as measured by AuM or advisement, ranging from more than US\$15 billion-less than US\$1 billion

Result: The most detailed industry survey to date of awareness, preparation, planning and actions to comply with cost basis reporting rules from key decision-makers

**Results: Where Does the Industry
Stand on Cost Basis Reporting?**

Overall awareness of new cost basis reporting rules

Awareness and concern levels are elevated, but not sufficiently

Familiarity (Summary)

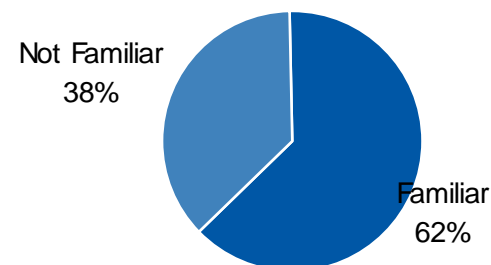
- Almost two-thirds (62%) of the respondents are familiar with the new laws
- Concern over compliance is at similar levels (58%)
- Concern levels at:

High

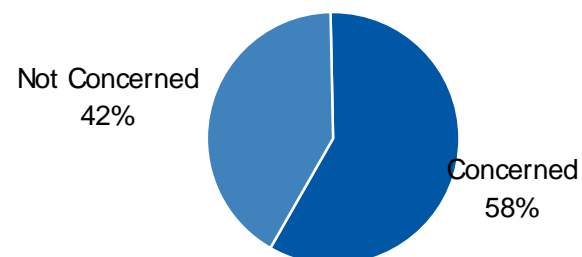
- AM/hedge funds (64%)
- broker-dealers (63%)
- mutual fund companies (63%)
- banks (60%)

Low

- investment advisors (36%)
- We are not convinced awareness is at an adequate level



Concern (Summary)



Source: Celent in conjunction with Wolters Kluwer Financial Services; Note: We believe a response rate at or near 60% reflects a reasonably healthy awareness and concern over compliance with new laws in general

Concern over new cost basis reporting rules by role



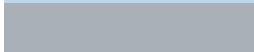
Within firms, operations and tax personnel are most concerned

- Tax (74%) and operations (63%) personnel are much more likely to be concerned with the new laws
 - A significant burden will fall on these individuals

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; Note: Response rate cutoff of 60% used

Concern over components of new cost basis reporting rules by firm/focus area

Centered upon systems and timeframes

- Concern over compliance is centered upon the following components:
 - meeting regulatory timeframes
 - having proper systems in place
- Operations and tax personnel are most concerned about all of these components
- Staffing levels and training are secondary concerns at this point

Types of Concern over New Rules- By Firm

	Broker/Dealer	Investment Advisors	Mutual Fund Cos.	Bank	AM/Hedge Fund/Other
Meeting time frames	60%	35%	50%	64%	67%
Appropriate systems	59%	30%	53%	60%	74%
Adequate Training	52%	32%	52%	52%	58%
Appropriate staffing	62%	36%	38%	57%	55%

Types of Concern over New Rules- By Focus Area

	General Mgmt or Exec	Compliance	Operations	Portfolio Mgmt	Tax	IT/Legal/ Risk Mgmt
Meeting time frames	56%	46%	62%	43%	66%	45%
Appropriate systems	50%	42%	60%	50%	66%	48%
Adequate Training	28%	38%	56%	39%	58%	46%
Appropriate staffing	33%	46%	51%	46%	67%	46%

Key

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

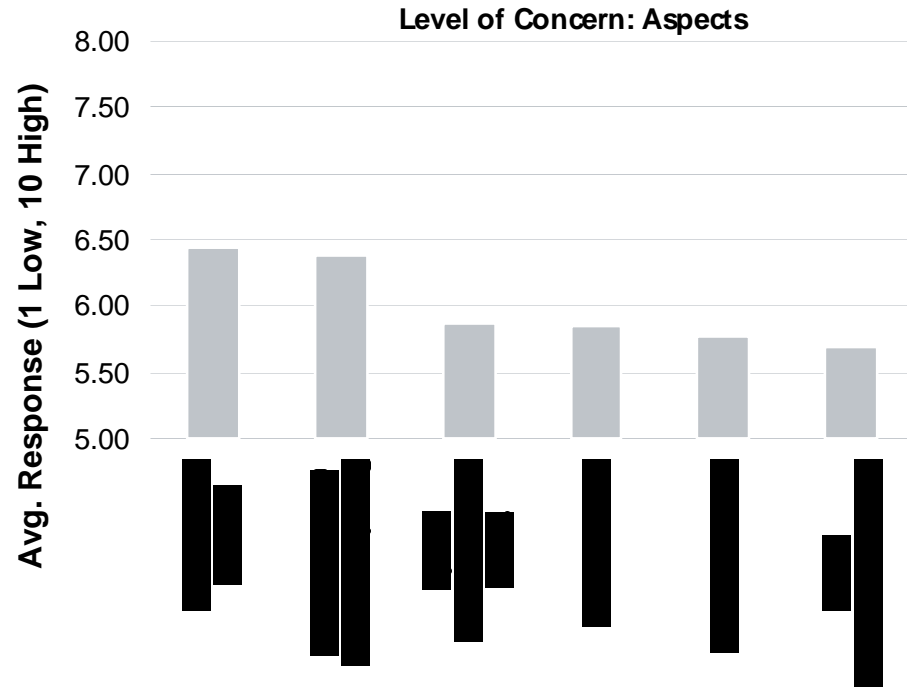
Source: Celent in conjunction with Wolters Kluwer Financial Services; Note: Response rate cutoff of 60% used

Concern over various aspects of new cost basis reporting rules overall

Basis method elections and reconciliation with customer reporting are top concerns

Aspects of new rules

- **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.
- **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.
- **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.
- **Transfer reporting.** (1) What information should be included. (2) Considerations around the 15-day required reporting period. (3) Applicability to partial transfers.
- **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.
- **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.



Systems features preferences

Core features broadly supported

- Core features emphasized on supporting:
 - accurate wash sale adjustments
 - accurate corporate actions adjustments
 - a variety of lot release methods
 - bifurcation of accounts
- Broker-dealers and mutual funds rate different system features highly overall

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; To gauge the importance of system features, we used a cutoff of 85% of responses to determine if a system feature was important, to reflect that respondents were given a wish list

Summary of awareness, concern and system preferences from our survey

Summary of survey results

By firm	<ul style="list-style-type: none">▪ Most concerned: broker-dealers, mutual funds, asset managers/HFs, banks▪ Least concerned: investment advisors
By role	<ul style="list-style-type: none">▪ Most concerned: operations, tax, general mgmt/exec▪ Least concerned: compliance, portfolio management, IT/legal/risk management
Concern components	<ul style="list-style-type: none">▪ Primary: Appropriate systems, meeting time frames, staffing (broker-dealers only)▪ Secondary: Staffing, training
Various aspects	<ul style="list-style-type: none">▪ Basis method elections and reconciliations are top concerns▪ Broker-dealers and mutual funds most concerned with just about every aspect of the new law
System preferences	<ul style="list-style-type: none">▪ High importance: accurate wash sale adjustments, accurate corporate actions adjustments, a variety of lot release methods▪ Low importance: support for short sales, options, and fixed income

Concerns depend on where the firm and respondents sit in the securities operations chain, but concern levels stand out at broker-dealers, mutual funds and among operations and tax personnel. System preferences reflect this concern.

Results: Progress So Far

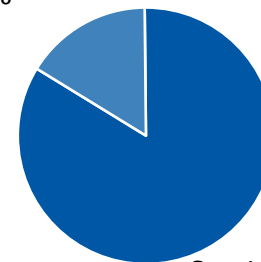
Industry Planning/Preparation for Compliance

Under Way, But Slow Going

Preparation (Summary)

- 84% of respondents have done some type of research to prepare for the new laws
- Operations and tax personnel are doing the most to prepare for compliance

No Research or
Prep so far
16%



Conducted
research
84%

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

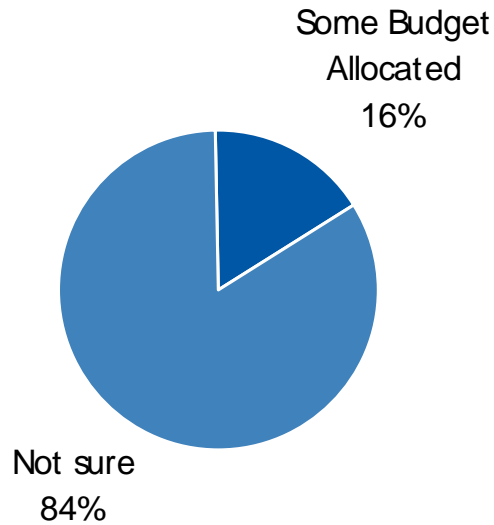
	Frequent prep	> 60% of respondents
	Average	40-60% of respondents
	Unfrequent prep	< 40% of respondents

Source: Celent in conjunction with Wolters Kluwer Financial Services; Note- response rate cutoff of 60% used and respondents selected all applicable answers

Allocation of time and budgets: lack of substance

Industry implementation and the lack of urgency

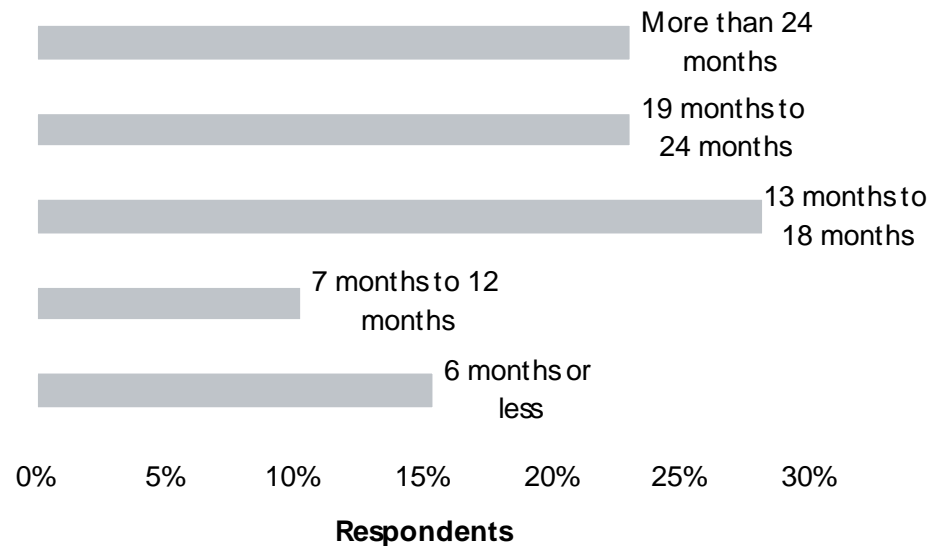
Budget Allocation (Summary)



- 75% that have allocated time view solutions implementation as an exercise that will take at least 13 months

- Only 16% have any budget allocated at all
 - Lack of urgency may create a difficult environment for firms
- Time allocated to compliance is a much more important consideration than budget at this point

Time Allocation (of those who have allocated time)



Source: Celent in conjunction with Wolters Kluwer Financial Services

Cost Basis Reporting: summary of progress

What is the Industry Already Doing?

- ✓ 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
- ✓ Tax personnel are the most acutely aware of the obligations and requirements to be placed on them
- ✗ However, some firms have yet to allocate budgets and many do not have any implementation plans in place
- ✗ 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
- ✗ **Overall industry progress seems inappropriately weak, given the scope of the new requirements and the needed implementations and modifications of technology systems and operations**

What Should the Industry Do?

- 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
 - business prospects
 - relations with regulators, including fiscal penalties
- **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**



A Call to Action: Next Steps for Executives

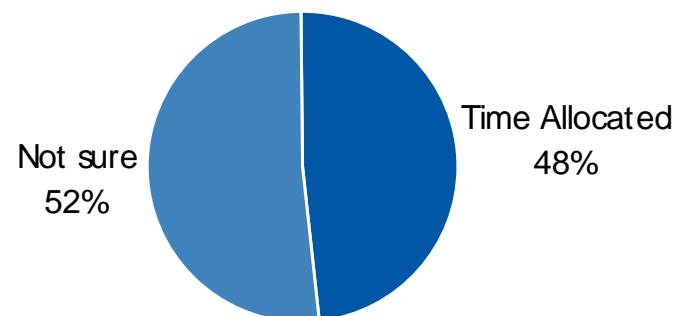
A Call to Action

Industry implementation and the lack of urgency

- We are concerned about progress so far by the industry to meet compliance
 - The timeline is short and the issue is complicated
- Our call to action arises primarily from the fact that:
 - While 48% of affected respondents have allocated some time to meet the new requirements...

...a whopping 52% are not sure, reflecting over-optimism about the amount of time to deliver a solution

**It's About Time: Cost Basis Reporting Compliance
48% have allocated time, 52% aren't sure**



We believe that the industry has wholly underestimated the amount of time necessary to implement cost basis reporting solutions

Source: Celent in conjunction with Wolters Kluwer Financial Services

Time for action from C-level executives

Next steps for meeting compliance by January 2011

Ideal timeline

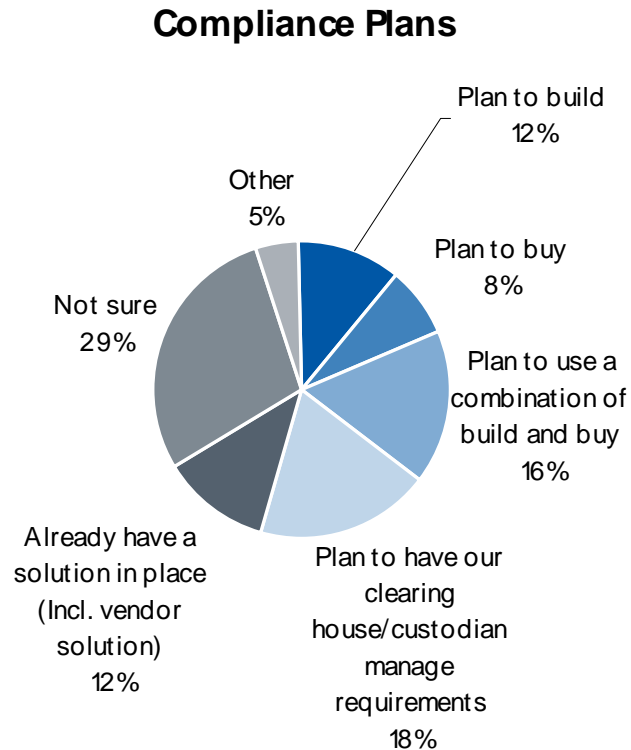
Summer/Fall 2009	<ul style="list-style-type: none">▪ End of research and beginning of compliance planning process▪ Decision: buy, build, or combination?▪ Development of solution plan and timeline
Winter 2009	<ul style="list-style-type: none">▪ Vendor selection and proof of concept
Spring 2010	<ul style="list-style-type: none">▪ Solution development and implementation
Summer 2010	<ul style="list-style-type: none">▪ Complete implementation, testing/compliance
Fall/Winter 2010	<ul style="list-style-type: none">▪ Final testing/compliance/go live
Spring 2011	<ul style="list-style-type: none">▪ Ongoing compliance

To reach ultimate compliance, executives should begin directing their teams to develop requirements and roadmaps and/or reached out to trusted vendors very soon

Compliance plans are varied

36% of respondents will depend on a third-party solutions

- A detailed look into aggregate compliance plans from our respondents reveals that:
 - 29% are not sure
 - 12% believe they already have a solution vendor in place
 - 12% plan to build
 - 8% plan to buy
 - 16% plan to use a combination of build and buy



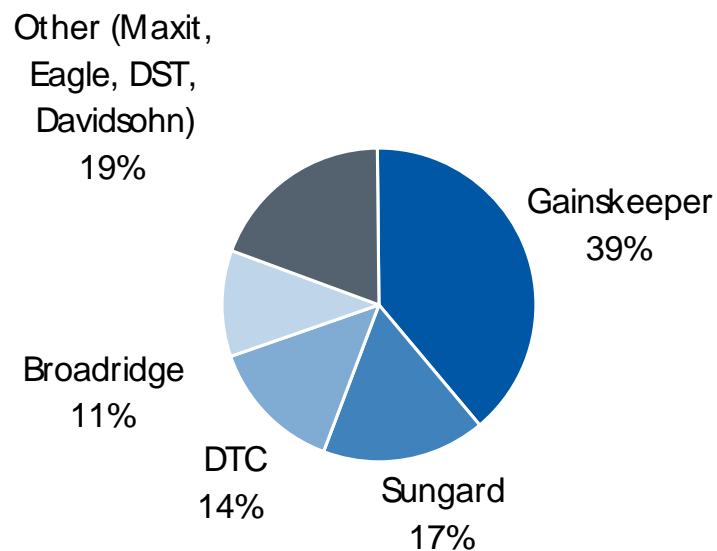
Source: Celent in conjunction with Wolters Kluwer Financial Services

Vendor recognition

A wide variety of firms cited, with GainsKeeper most cited

- At 39% of respondents GainsKeeper (Wolters Kluwer, CCH, and Capital Changes) was the most cited vendor, followed by:
 - Sungard 17%
 - DTC 14%
 - Broadridge 11%
 - Others 19%
 - includes Maxit (SciVantage), Eagle, DST, and Davidsohn, for example

Vendors Cited by Respondents



Source: Celent in conjunction with Wolters Kluwer Financial Services

Conclusions

Where do we go from here?

Avoiding undesirable outcomes

- The complex nature of the new law and the potential for consequences for noncompliance mean a lack of progress can lead to some undesirable outcomes, including direct and indirect costs

- Direct costs
 - Penalties (IRS)
 - ! For instance, failure to provide the IRS and taxpayers with correct cost basis reporting information could subject brokers to tax penalty risk
 - ! According to Wolters Kluwer, 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.
 - Customer inquiries regarding incorrect 1099s

- Indirect costs
 - Reprocessing 1099s
 - Reputational risk
 - Will clients move their account?



Where do we go from here?

A better road

- 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
- To reach ultimate compliance, executives should begin directing their teams to develop requirements and roadmaps and/or reached out to trusted vendors very soon
- Firms must move beyond research into actual planning and development, whether through internal resources or through partnerships with technology vendors and other key providers

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Closing remarks

- Results are significant – not just budget, but also TIME
- Public comments to the IRS & forthcoming guidance
- Stay current with developments about this law at www.costbasisreporting.com
- Welcome Stevie Conlon



Q&A

- Visit www.costbasisreporting.com
 - For more information about the law
 - To learn about how GainsKeeper & Capital Changes can assist with compliance