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Prepare now for options and fixed income cost-basis reporting

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Brokers and custodians now have an extra year to report to investors the adjusted cost basis for options and fixed income instruments. The extension will give firms more time to prepare, either by working with vendors or creating in-house solutions. However, this complex undertaking requires a smart, comprehensive plan grounded in the harsh realities inherent in buying or building software to solve business problems, and planning should begin now.

These Internal Revenue Service (IRS) amendments direct brokers to follow customers' instructions and elections when determining adjusted basis. The amendments also provide that, when a broker transfers securities to another new broker before their sale, the transferring broker must furnish to the receiving broker a statement containing sufficient information about the transferred securities for the receiving broker to determine the customer's adjusted basis and whether any gain or loss is short-term or long-term when the transferred security is eventually sold.

Firms may have systems in place that calculate the cost basis for equities, mutual funds and exchange-traded funds -- the first and second phases of these reporting rules. In most cases, this same system should also be able to handle the cost basis for debt and options transactions. However, if firms do not have an effective system in place, they may have even more work ahead of themselves, since calculating the cost basis for fixed income and options instruments is sometimes more complex than for equities and mutual funds.

Key considerations for options and fixed income cost-basis reporting

Asset class inventory

Analyze what kinds of assets the firm holds. Create a checklist and verify which asset classes are traded by your firm and your clients. Have a forward-looking approach, and make sure your firm is ready for anything the front office expects to trade in the next 24 months.

GAP verification

Analyze what the firm can already do. Examine what the firm has and what is needed and examine any gaps. These gaps might exist in terms of technology (*e.g.*, the current cost-basis solution might lack a way to distinguish between a bond and a stock) or problems could exist in the operations department.

In some cases, technology and operations teams may both need some training to understand the nuances of how cost basis integrates with the new instrument classes. For example, does the operations team know that when it exercises a call option, the cost basis of the options needs to be added to the strike price to calculate the correct cost basis of the newly acquired equities?

Technology upgrades

If the firm trades either fixed income or options securities, compliance will likely find gaps in two major technology areas upon its investigation — data acquisition and data storage.

- *Data acquisition*. When it comes to options and fixed income, there are all kinds of strange new data elements that need to be accessed to track their cost basis. One example is pay-downs, a transaction wherein the loan underlying an asset-backed security is paid off early by the original borrower. A typical case can occur when a mortgage holder sells a house or pre-pays a chunk of principal. This causes the cost basis of the asset-backed security to decrease. How are you going to know this occurred, unless you use a service that lets you know?

- *Data storage*. The firm has completed the data acquisition stage. What does the firm's operations team do with the avalanche of data you just acquired? You need to put it somewhere, and it should to be stored where your cost-basis engine can find it and get to it quickly.

Operational changes

As technology departments put new systems in place, firms will need to train their operations teams how to use all the new features and functions and create operational workarounds for those that cannot be easily addressed.

Importantly, the firm needs to implement business training for the operations staff. Never mind what happened in the past. Now, the operations staff needs to know exactly how a convertible bond differs from a convertible preferred share and how conversion of either type can affect the cost basis of the final shares acquired via a conversion transaction.

Procurement

If only things could be so simple as the following scenario: When you go to the supermarket and want to buy some soda, and you see Coke on one shelf and Pepsi on another, you make up your mind, buy a six-pack, and proceed to the checkout counter. Five minutes later you are enjoying a carbonated, caffeinated and sweetened beverage.

The cost-basis rules pushed the burden of the cost-basis determination from the individual investor over to the large, faceless broker-dealers who cannot make technology purchases in five minutes. Instead, they must deal with a procurement process that is often painful, frustrating and time-consuming. This process (which should be concerned with two things-- business requirements and the best IT solution) can become highly political, as everyone has a friend or family member in the industry to recommend. It is important to make an impartial judgment call on an IT solution for the firm – and compliance should be a part of this impartial team.

Implementation

Once the firm decides on technology and it is purchased, remember that not every element of the problem can be solved with off-the-shelf software. And even where it can be, the software still needs to be integrated with your preexisting systems. Clients do not want to receive separate 1099(b) forms for equities, fixed income and options.

It is time to build some software to fill in the gaps. Find the right person to make sure the firm's systems of retrieval and storage are fully integrated.

Report analysis and public information

All the pain and suffering from the prior steps serve no purpose unless the client can see the data that the cost-basis regulations require the firm to deliver.

The amendments require issuers of securities to file a return with the IRS and furnish a statement to holders of the securities after taking a corporate action that affects the basis of the security to explain the corporate action and its quantitative effect upon the basis of the security.

Most firms have high-value websites that deliver fancy-looking reports to clients on a daily basis, but none of these reports include the all-important cost-basis data points. The firm will need to enhance some of its existing reports by implementing the cost-basis reporting changes to the website and making this information available to clients.

Finally and most importantly, the chief compliance officer needs to make sure that a detailed document promises the C-level officers and board, plus the regulators, that the data in the firm's cost-basis reports are compliant with the IRS' amended rules.

George Michaels*, is the CEO of G2 FinTech, a provider of tax compliance and regulatory software, and a frequently quoted authority on the tax analysis of securities transactions. He regularly authors white papers and articles on complex tax issues and industry trends.*