

Mutual Funds and Cost Basis Compliance

ON OCT. 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act, which contains a provision that will require brokerage firms and mutual fund companies to track and report adjusted cost basis information to investors and the IRS. Due to the economic issues gripping the financial services industry, the basis reporting regulations went largely unnoticed. However, the legislation is significant, and little time exists for firms to properly prepare to comply with the reporting requirements.

With just over a year before reporting equities becomes required, brokerages should be well into the planning stages for purchasing and implementing a cost basis system. Many firms, however, have failed to begin planning, let alone commence the lengthy process of selecting, testing and implementing systems. This procrastination by the fund industry may have a dramatic impact on business operations and investor satisfaction over the long term.

Security-specific rules and the current state of cost basis offerings create unique, often challenging problems for mutual fund companies. Fortunately for investment management firms, the legislation does not impact pure mutual fund providers until January 2012. (Those firms with brokerage arms will be required to cover equities beginning in 2011.)

Historically, mutual fund providers have used Average Cost as the default lot relief method (LRM). The new legislation requires that shareholders be allowed to select the LRM of their choice. This process can be very difficult for firms to resolve and undoubtedly will change the nature of the relationship between firms and shareholders. Satisfying this requirement means opening a communication channel with the shareholders. If executed poorly, the result is a confusing and unsatisfying experience for the client and a time-consuming and costly exercise for the firm. Those firms that focus solely on achieving the bare minimum necessary to be in compliance with the new legislation are likely to fail in the overall execution of cost basis implementation.

Brokerages and fund companies have four options available for automatically adjusting cost basis: retrofit a legacy system that currently maintains some form of cost basis tracking, develop a new in-house system from the ground up, rely on the back-office provider or transfer agent to implement a solution, or contract with a dedicated cost basis vendor to provide com-

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prehensive tracking and reporting services.

For large firms, which frequently develop systems in-house, retrofitting a legacy system may seem reasonable at first. But attempting to support complex cost basis issues with a system that was not designed specifically to support cost basis can yield poor results. The final system is likely to be costly to build, costly to maintain or both.

Custom-build projects are notoriously expensive. But the greater issue at this point, even for deep-pocket firms, is time. A custom-build project may take two to four years to complete requirements, development and testing.

Many transfer agents offer some form of a cost basis solution. Transfer agent solutions, however, often provide minimal functionality and limit the availability of data for other applications. Further, the systems tend to not be entirely automated, leading to reconciliation headaches (and costs) for a firm's operations team. Generally the transfer agent cost basis offering will suffice for small firms, but will not be adequate for larger, more innovative firms. Cost basis vendors typically offer the most robust solutions but may, at first glance, appear to be more expensive, as transfer agents may bury the expense of cost basis systems in the overall relationship billing.

A Changing Client Relationship

The impact of mandatory basis reporting is not limited to technology acquisition. The very nature of the relationship between firm and client must evolve. Investors will be allowed to use any lot relief method they desire. This necessitates a new, more open communication channel. Failure to provide an intuitive, accessible method for indicating accounting methods will lead to a surge in support costs related to assisting confused customers.

The customer support angle is particularly compelling.

While most of the focus has been on compliance — and for good reason — firms have not fully considered the impact on customer support. With the spotlight now on cost basis, shareholders are likely to ask more tax questions about every position in their portfolios, including non-reportable lots.

Vanguard has already begun to think beyond compliance to identify the various ways basis reporting will impact the firm. “Even though a firm is not obligated to provide assistance on pre-effective shares, it will lead to an increase in support traffic,” suggests Charles Portale, Vanguard product manager, Retail Investor Group. “The manner in which each firm handles these inquiries could have a significant impact on the customer experience.”

He Who Hesitates Is Lost

Another issue facing firms is the scarcity of resources, both internally and externally. As the deadline for reporting approaches, competition for qualified resources will increasingly drive up development costs. By implementing ahead of the last-minute surge, firms will have the best opportunity to manage cost.

Finally, firms that delay implementation of a comprehensive system will be at a competitive disadvantage to firms that are more proactive. Many fund companies will assume that their cost basis offering will be measured against other fund-only firms, which share the 2012 tracking deadline. It is important to note, however, that clients will begin receiving adjusted cost basis data from their brokerages in 2011. This means customers will receive tax reporting assistance, in the form of adjusted cost, from their brokerage but not their fund company. At a minimum, this will lead to client confusion and a spike in help desk traffic; but in some cases, it could also result in dissatisfaction leading to a shift in assets.

Furthermore, many large fund firms also have a brokerage (e.g., Vanguard and Fidelity Investments). Likewise, many large brokerages are also players in the mutual fund space (e.g.,

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Charles Schwab). Although no information is available about specific firms' development efforts, it is reasonable to assume that some, if not all, of these firms will integrate mutual funds into the cost basis solutions that they implement for the 2011 securities reporting deadline.

The potential for lost market share should not be trivialized. Those companies that introduce cost basis systems next year will not only get ahead of the legislation, they will be perceived as innovators within the industry and potentially be rewarded with in-flows from firms that are slow to respond.

Firms that identify the regulations as an opportunity to offer innovative, value-added cost basis tools and online data presentation to their clients will differentiate themselves and become the clear front-runners as clients become more focused on the need for cost basis information. Choosing a fully featured, innovative cost basis system sends a strong message to the industry that your firm is committed not just to meet the requirements of government regulations, but to do so while exceeding the expectations of your clients and the ability of your competitors.

One last point to consider in evaluating cost basis options is that cost basis is volatile. Tax rules change, new asset classes are developed, the demand for basis in other products evolves and new ideas for related tools continue to emerge. If a firm hasn't already demonstrated a solid track record of cost basis innovation, it is unlikely to innovate in the future. Make the wrong selection and the functionality a firm buys today could be all it is provided with three or four years later.

And don't overlook the chance to have a positive impact on your customers. Investors have always struggled with tax reporting. Mandatory reporting or not, providing adjusted cost basis to shareholders improves the overall investment experience and increases customer loyalty. The sooner your firm implements a cost basis solution, the sooner it will reap the benefits of an improved customer experience. ♦

Complex Calculations

Many fund shops do not feel a sense of urgency to implement a cost basis reporting solution prior to the mandatory deadline. But this is a risky decision. Accurately calculating adjusted cost basis is no small task. Cost basis tracking systems for mutual funds need to account for the following complexities:

- Wash Sales
- Dividend Reinvestments
- Multiple Lot Relief Methods
- Holding Period (short-term vs. long-term)
- Sales Loads
- Fund Reclassifications
- Method of Acquisition (purchase, inheritance, gift)
- TOA Out (firms will be required to include cost basis information)
- TOA In (firms will be required to reconcile any missing information)
- Corporate Actions
- Bifurcation of Tax Lots (two-bucket system)



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