

COST BASIS PROCESSES AT SCHWAB

This document is designed to provide guidance with some of the fundamental processes affecting the cost basis of investments.

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LOT INSTRUCTION DEADLINES

You have the option to provide specific lot instructions as opposed to using the default cost basis method. You can specify lots online through the Web Trading Applet for equities.

TYPE	HOW TO SPECIFY LOTS	DEADLINE
Trades	<ul style="list-style-type: none">• Complete online through the Web Trading Applet.• Upload instructions with the trade file.	At time of trade or post-trade prior to settlement date
Journals*	<ul style="list-style-type: none">• Attach instructions to the Check and Journal Request form.• Fax instructions to your service team for journals submitted via the online Move Money tool.	At time of journal
Gifts	<ul style="list-style-type: none">• Include instructions on the Charitable Gift Transfer LOA form.	At time of gift
Transfers	<ul style="list-style-type: none">• Use the gifting form.• Include instructions with the Letter of Authorization for transfer outside Schwab.	At time of transfer request

*When amortized fixed income assets are journaled, the amortized cost basis at the time of the journal will display as the original cost basis in the new account.

RECONCILING DATA

Advisors should reconcile daily to ensure that your firm data and Schwab data are in sync. If you are using a portfolio management system (PMS), it probably has a way to automatically reconcile the two data sources. You can also reconcile manually by using Excel. Schwab is working with various PMS providers to incorporate this new functionality into the application.

- **PortfolioCenter®**—PortfolioCenter will use the Daily UGL file at the lot level for taxable accounts. Position-level data will continue to be provided as it is today. PortfolioCenter has added a new reconciliation report to help advisors reconcile between PortfolioCenter and Schwab. The output from PortfolioCenter is a report showing any discrepancies between Schwab and the firm. The PortfolioCenter website has more details.
- **Axys**—Advent Axys will use the Daily UGL position file for taxable accounts to post and reconcile cost basis. The Advent website has more details.
- **Other PMS Vendors**—Schwab has provided file specifications to third-party PMS vendors. Contact your vendor for specifics on how to reconcile data files.

Excel—Although advisors cannot view the cost basis data files in the existing SchwabLink® Desktop or

Schwab Data Delivery® viewers, you will be able to view these files in Excel. To open cost basis files in Excel, take the following steps:

1. Open Excel.
2. Select “Open.”
3. Select “All Files” from the Files of Type drop-down.
4. Navigate to the folder where download files are stored and select a file to open.
5. In the Text Import Wizard, select “Delimited” for the Original File Type.
6. In step 2 of the Text Import Wizard, select “Other” for the Delimiter and enter a pipe character (|).
7. Click “Finish.”

Please note that Excel will automatically drop zeroes from numeric values. If you want decimals to line up for dollar amounts or other variables, you will need to do additional column formatting.

View [detailed file specifications](#) on the Schwab resource page.

Once you have downloaded the data files, you can review the line item details to verify that the action Schwab took matches your instructions.

LOT MISMATCH

If Schwab cannot follow your specified lot instructions, you will receive a Cost Basis Lot Instructions Alert that indicates what action we have taken. If you need to make changes to the trade to ensure that it is executed as you intended, you can do so before the settlement date.

You may receive this alert under two circumstances:

- **Partial match:** If your lot instructions match either the original purchase date or the purchase price, but not both items, we will alert you of a partial match. In this case, we will close out the lots we believe you have intended to specify.
- **No match:** If we cannot match lots to your instructions, the alert will indicate that we could not match your lot instructions. Because we could not find the lots you specified, we will use the account's default cost basis method instead.

You can adjust the lot instructions as long as you do so before the settlement date for your trade. First you must determine which set of data is correct, your firm's data or Schwab's data.

If Firm Data Is Correct

To correct Schwab's data, take the following steps:

1. Log in to Schwab Advisor Center™ and launch the Web Trading Applet.
2. Find your trade in the Order Status by Account tab.
3. Highlight the order.
4. Click the Specify Lots button. This will launch an overlay that will allow you to add or edit lot instructions.

5. Use the Specified Lot Trading functionality to submit changes to your instructions.

Alternatively, you can contact the Advisor Services Client Reporting Team via email at ascostbasis@schwab.com or by phone at 877-762-6446.

Please note that regulations do not allow changes to lot instructions after the settlement date. You will need to adjust your PMS to match Schwab data.

If Schwab Data Is Correct

To correct the firm's data, take the following steps:

1. Adjust the data in your PMS to match Schwab's data. You may have a tool to import data from the Schwab data files, or you may need to make corrections manually.
2. Contact your PMS vendor for specific details on how to import data.

After correcting a lot mismatch within either system, review the data files the next day to ensure that the systems are in sync.

RETURN OF CAPITAL

A return of capital event occurs when Schwab receives an updated file from our third-party vendor informing us that an issuer has reclassified income previously paid to return of capital. When this happens, you will receive a Cost Basis

Adjustment Alert when cost basis is automatically updated from a return of capital adjustment. This will enable you to more easily reconcile your cost basis information and make sure your data stays in sync with ours.

CASH/STOCK MERGERS

Historically, in a cash/stock merger, Schwab has taken the cost basis from the parent company and moved it to the child company. We have assumed the cash to be 100% taxable.

The new cost basis legislation has resulted in a reevaluation of how we determine cost basis on cash/stock mergers. Mergers in which a gain/loss limit is applied will require the fair market value (FMV) price of the distributed security (child security) to determine total proceeds that are being distributed. The total proceeds used to determine overall gain/loss will be the child security FMV plus the cash received. However, the gain/loss limit will adjust the realized gain/loss that is actually being reported.

Gain/loss limit rules result in three possible realized gain/loss outcomes:

1. **Gain limited to cash received**—Total proceeds minus cost basis results in a gain greater than the cash received in the cash/stock merger. Only the cash received will be reported as a gain.
2. **Full gain**—Total proceeds minus cost basis results in a gain less than the cash received in the cash/stock merger. The full difference between proceeds and cost basis will be reported as a gain.
3. **No loss**—Total proceeds minus cost basis results in a loss. The IRS does not allow a loss to be claimed. Schwab will report cost as equal to proceeds so there is no loss recognized.

The amount of cost basis reported in RGL will be deducted from the cash basis of the child security.

Cash/stock mergers are covered as of January 1, 2011, and Schwab is required to report cost basis to the IRS. To align all cash/stock merger transactions to the algorithm outlined above, Schwab will retroactively change all cash/stock mergers for 2011 with gain or loss limits in December 2011.

To adjust your data, contact your PMS provider.

MISSING COST BASIS ON 1099

Schwab will report cost basis on Form 1099 Composite for covered and uncovered securities. Some accounts will show that cost basis is missing. Most likely this is because the security was transferred from another financial institution and Schwab does not have the necessary information to determine cost basis.

You can determine whether your clients' accounts have missing cost basis by the following methods:

- You can view status on individual accounts through the Cost Basis tab on Schwab Advisor Center. The account will indicate "missing" in the cost basis column.
- To view status at the master level, use the daily download file, sort the Excel spreadsheet by cost, and all the masters showing zero cost will appear together.
- Send a request via "Contact Us" from the Cost Basis tab on Schwab Advisor Center, provide the master numbers, and request a missing cost basis report. Please allow two to three days to receive the report.

To provide cost basis information to Schwab, you can take the following steps:

- Determine where the security was purchased.
- Review original statements or confirmations, or request them from the purchasing broker.
- Check past statements and trade confirmations for the original purchase dates and prices.
- Contact the broker who transferred the securities to Schwab, or search online services such as NetBasis to obtain the data.
- Send the cost basis edit form to Schwab or edit the cost basis information on the cost basis page of schwabadvisorcenter.com.

WASH SALES AND DISALLOWED LOSSES

A wash sale occurs if you sell securities at a loss and buy substantially identical replacement shares within 30 days before or after the sale. The wash sale period for any sale at a loss consists of 61 days: the day of the sale, the 30 days before the sale, and the 30 days after the sale. The wash sale rule postpones losses on a sale if replacement shares are bought around the same time.

If a wash sale occurs, the loss incurred on the original sale is disallowed, the disallowed loss is added to the cost basis of the replacement security, and the holding period for substantially identical stock or securities you acquire in a wash sale includes the period you held the old stock or securities.

To calculate the adjusted realized gain/loss, you need to determine:

1. The wash sale disallowed loss %

$$= \frac{\text{total \# of wash sale shares (shares repurchased)}}{\text{total \# of shares sold}}$$

2. The disallowed loss amount

$$= \text{wash sale disallowed loss \%} \times \text{original loss (in dollars)}$$

3. The adjusted realized gain/loss

$$= \text{original loss amount} - \text{disallowed loss amount}$$

To calculate the adjusted holding period date, start with the closed lot acquisition date and add days not held.

That is, the acquisition date is adjusted on the new lot to equal the closed lot acquisition date plus any days that it was not held.

Lots are chosen based on the default accounting method assigned to the account or specified instructions given at the time of trade.

HOW DOES A WASH SALE WORK?

Transactions over a 30-day period, beginning with a flat position, are being used for this example:

9/30/2010	BUY	100L	ABC	\$1,000.00
10/3/2010	SELL	50S	ABC	\$400.00
10/16/2010	BUY	1.250L	ABC	\$15.60

Wash sale triggered

Realized Gain/Loss

10/3/2010	SELL	50S	Proceeds (\$400.00) - Cost (\$500) = <\$100.00 \$97.50
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1. Some of the loss is disallowed; the dividend reinvestment of 1.250 shares is considered a buy. You are only able to claim a loss of \$97.50 (the loss on the shares that were not repurchased).





New Lots for ABC

9/30/2010	BUY	50L	ABC	\$500.00
10/13/2010	BUY	1.250L	ABC	\$18.10

3. Acquisition date is adjusted on the lot to equal the closed lot acquisition date plus any days that it was not held (9/30 + 13).

2. Cost is adjusted on the lot by the disallowed amount (the total amount of the loss on the sale; \$15.60 + \$2.50 = \$18.10).

OPTIONS EXERCISES AND ASSIGNMENTS

Seller (Writer)		Buyer (Holder)	
Summary	Cost Basis Impact	Summary	Cost Basis Impact
Call <ul style="list-style-type: none"> Has short options position (wants to sell a security) Collects a premium Has obligation to sell if option is exercised 	 Increase sales proceeds on sell of underlying security by option premium received	<ul style="list-style-type: none"> Has long options position (wants to buy a security) Pays a premium Has right to exercise option 	 Increase cost basis on buy of underlying security by option premium paid
Put <ul style="list-style-type: none"> Has long options position (wants to buy a security) Collects a premium Has obligation to buy if option is exercised 	 Decrease cost basis on buy of underlying security by option premium received	<ul style="list-style-type: none"> Has a short options position (wants to sell) Pays a premium Has right to exercise option 	 Decrease sales proceeds on sell of underlying security by option premium paid

Example: Sell Call Assignment

In a sell call assignment, the proceeds are adjusted by the option premium.

- Bill Blevins held 100 shares of ABC Corporation, which he bought for \$120 per share.
- He sold (wrote) 1 ABC Oct \$130 call @ \$5, and he received a premium of \$500.

proceeds	\$13,000
– cost of underlying stock	– 12,000
= realized gain or loss	= 1,000 (realized gain)
+ option premium	+ 500
= adjusted realized gain or loss	= \$1,500 (adjusted realized gain)

- The call was assigned, meaning that the call option holder exercised the right to purchase the security.
- Mr. Blevins sold 100 shares of ABC at \$130 per share. He received \$13,000 (100 × \$130) in proceeds from the option holder.

proceeds	\$13,000
+ option premium	+ 500
= adjusted proceeds	= 13,500 (adjusted proceeds)
– cost	– 12,000
= adjusted realized gain or loss	= \$1,500 (realized gain)

Sellers add their premiums to the proceeds of the underlying stock sold through options. The closing date of the underlying security is the effective date of the exercise. There is no realized gain or loss on the option itself.

The call option holder who exercises the right to purchase adds the premium to the cost basis of the shares. The opening date of the underlying security is the effective date of the exercise. There is no realized gain or loss on the option itself.

Example: Buy Put Exercise

In a buy put exercise, the proceeds are adjusted by the option premium.

- Bill Blevins held 200 shares of XYZ Solutions, which he bought for \$5 per share.
- He bought (held) 2 XYZ Nov \$7 put @ \$1.50 and paid a premium of \$300.
- Mr. Blevins exercised the put, meaning that he had the right to sell the security to the option writer. Mr. Blevins sold 200 shares of XYZ at \$7 per share. He received \$1,400 (200 × \$7) from the option seller.

proceeds	\$1,400
– option premium	– 300
= adjusted proceeds	= 1,100 (adjusted proceeds)
– cost	– 1,000
= realized gain or loss	= \$100 (realized gain)

Put option buyers (holders) pay the premiums, so they subtract their premiums from the proceeds of their sales of shares of the underlying security. The opening date of the underlying security is the effective date of the exercise. There is no realized gain or loss on the option itself.

Put option sellers (writers) subtract the premiums received from the cost basis of the underlying shares purchased through the options. The closing date of the underlying security is the effective date of the exercise. There is no realized gain or loss on the option itself.

CASH IN LIEU (CIL) OF FRACTIONAL SHARES

Our corporate action department delivers whole shares into an account during a corporate action. The fractional shares are not credited to the account and sent to be sold when the firm receives payment for the CIL; the cash is credited to the account. Our cost basis engine credits

the fractional shares to the account during a corporate action, and they are subsequently sold off when the cash is received for the CIL. This causes a temporary “out of balance” until the CIL payment is received.

For informational purposes only. The information is not intended to provide specific financial, tax, compliance, or legal advice. You should consult professionals in these fields to address your specific circumstance.

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