

MEMO# 12030

June 19, 2000

REVISED DRAFT INSTITUTE LETTER ON SEC AFTER-TAX RETURNS PROPOSAL

[12030] June 19, 2000 TO: SEC RULES COMMITTEE No. 89-00 TAX COMMITTEE No. 27-00
RE: REVISED DRAFT INSTITUTE LETTER ON SEC AFTER-TAX RETURNS PROPOSAL Attached is a revised draft comment letter on the SEC's proposal to require disclosure of after-tax returns in a fund's prospectus and in the Management's Discussion of Fund Performance ("MDFP").¹ The revised draft reflects the comments of members discussed at the June 8th meeting on the proposal and the Institute's original draft letter. The significant changes to the draft letter are discussed below. Comments are due to the SEC on the proposal by June 30th. Therefore, please provide any of the undersigned with your comments on the revised draft by June 26th. Amy Lancellotta can be reached by telephone at 202/326-5824 and by email at amy@ici.org. Keith Lawson can be reached by telephone at 202/326-5832 and by email at lawson@ici.org. Barry Simmons can be reached by telephone at 202/326-5923 and by email at bsimmons@ici.org. Disclosure in the Tax Section of the Prospectus The revised draft clarifies that if after-tax numbers are required to be disclosed in the tax section, rather than the risk/return summary as proposed, they should still be presented in a standardized tabular format, with required captions. In addition, the letter makes clear that before-tax returns should not be repeated in the tax section. Advertisements and Sales Literature The revised draft recommends that funds that include claims of "tax efficiency" in connection with showing fund performance in advertisements and sales literature should be required to also include after-tax returns. Do members agree with this recommendation? Required After-Tax Numbers The letter has been revised to strengthen the discussion relating to our recommendation that the new before-tax numbers should be eliminated and that both sets of after-tax numbers should reflect the deduction of any exit fees. In addition, the suggested caption headings of the table under the ICI's proposal have been revised to read as follows: • Returns reflecting the impact of taxes on fund distributions 1 See Memorandum to SEC Rules Committee No. 81-00 and Tax Committee No. 25-00, dated May 30, 2000 (transmitting the original draft letter). 2 • Returns reflecting the impact of taxes on fund distributions and sale of fund shares The letter has been revised to recommend that multiple class funds be required to show after-tax returns for only one class, rather than for all classes as proposed. The letter recommends that the same methodology used for selecting which class to reflect in a fund's bar chart in the risk/return summary be used for selecting which class to reflect in the after-tax returns table. The revised letter responds to the Commission's request for comment on whether disclosure of an after-tax returns index or a peer group should be required. The letter opposes such a requirement for the following reasons: (1) there currently are no appropriate indexes or established peer groups against which to compare the after-tax returns of most funds; (2) the reliability of a peer group of funds for those periods prior to the adoption of the proposal is questionable; and (3) any benefit of an index or peer group comparison would

be outweighed by the risk of overloading investors with too many numbers. Sample Tables To highlight the benefits of our various recommendations to the SEC's proposal, we plan to attach sample tables prepared in accordance with the SEC's proposal and in a manner that reflects our recommendations. Attached to the draft letter are sample tables for your review. Standardized Formula The revised draft reorders slightly the discussion of the standardized formula so that our requested changes -- (1) to use a representative tax rate and (2) to treat all hypothetically-redeemed shares as held for the long-term holding period -- are discussed before we discuss the aspects of the SEC's proposals that we support. The letter also clarifies that after-tax calculations are based upon tax information included on IRS Forms 1099-DIV and that a "subsequent recharacterization" is one reported on amended IRS Forms 1099-DIV. In addition, we have strengthened the discussion of why our recommendation to use the \$55,000 taxable income rate should not be inflation-adjusted. Exemptions from the Disclosure Requirement The revised draft defines both tax-exempt bond funds and taxable bond funds and presents arguments (without data) supporting our request to exempt each type of bond fund from the proposal. We added as a footnote to this discussion a request for clarification that providing tax-equivalent yields should not trigger a requirement to disclose after-tax returns. 3Filing Requirement The revised draft recommends that funds be permitted to file post-effective amendments to registration statements with the new after-tax returns disclosure pursuant to Rule 485(b) under the Securities Act. With respect to the compliance date, it has been suggested that funds that include after-tax returns in advertisements and sales literature should be required to include standardized numbers sooner than one year after the proposal is adopted, which is the transition period recommended in our letter. Do members agree? What would be an appropriate compliance date for such a requirement, six months after the date of adoption? Need for Reconsideration if Tax Laws Change A new section has been added to the letter to make clear that the SEC needs to reconsider this requirement if the current tax regime applicable to mutual fund shareholders changes. The letter notes that there are proposals currently under active consideration, for example, to permit investors to exclude some or all capital gains from taxable income and to permit fund shareholders to defer tax on reinvested capital gain distributions. If any proposals along these lines are enacted, the proposed after-tax returns disclosure may have little relevance. Amy Lancellotta Senior Counsel Keith Lawson Senior Counsel Barry Simmons Assistant Counsel Attachments Attachment (in .pdf format)