MEMO# 11743

March 21, 2000

SEC PROPOSES DISCLOSURE OF MUTUAL FUND ATER-TAX RETURNS

1 SEC Release Nos. 33-7809; 34-42528; IC-24339, dated March 15, 2000. A copy of the release is available on the SEC's website at www.sec.gov. [11743] March 21, 2000 TO: ACCOUNTING/TREASURERS COMMITTEE No. 11-00 SEC RULES COMMITTEE No. 44-00 TAX COMMITTEE No. 11-00 RE: SEC PROPOSES DISCLOSURE OF MUTUAL FUND AFTER-TAX RETURNS ____ The Securities and Exchange Commission has proposed rule and form amendments under the Securities Act of 1933 and the Investment Company Act of 1940 to require mutual funds to disclose after-tax returns based on standardized formulas.1 A copy of the SEC's release is attached and is summarized below. A meeting to discuss the proposal has been scheduled for Tuesday, April 25, 2000. The meeting will be held at the Hilton Garden Inn, located at 815 14th Street, NW, in the Georgetown/Kalorama Room. The meeting will start at 10:00 a.m., and lunch will be served following the meeting. Please respond to Stephanie Holly at 202/326-5814 or by email at sholly@ici.org by April 11, 2000 to let her know whether you will be attending the meeting. A. Location and Format of Disclosure The proposal would require funds to disclose after-tax returns in the risk/return summary of the prospectus and in the Management's Discussion of Fund Performance (MDFP), which is typically contained in the annual report. Before-tax and after-tax returns would be required to be presented in a standardized tabular format. Under the proposal, all fund advertisements and sales literature that include after-tax performance information would be required to also include after-tax returns computed according to the standardized formulas for computation of after-tax returns in the risk/return summary and MDFP. B. Standardized Formulas Funds would be required to calculate after-tax returns by using standardized formulas similar to formulas presently used to calculate before-tax average annual total returns. The proposal would require funds to disclose after-tax returns for 1-, 5- and 10-year periods on both a "pre-liquidation" and "post-liquidation" basis. Pre- liquidation after-tax returns assume that the investor continues to hold fund shares at the end of the measurement period and, as a result, reflect the effect of taxable distributions by a fund to its shareholders but not any taxable gain or loss that would be realized by a shareholder upon the sale of fund shares. Post-liquidation after-tax returns assume that the investor sells his or her fund shares at the end of the measurement period, and, as a result, reflect the effect of both taxable distributions by a fund to its shareholders and any taxable gain or loss realized by the shareholder upon the sale of fund shares. 2 Currently 39.6 percent for ordinary income and 20 percent for long-term capital gains. 2 Under the proposal, funds would be required to reflect the deduction of any fees and charges payable upon a sale of fund shares, such as sales charges or redemption fees, in post-liquidation after-tax returns but not in pre-liquidation after-tax returns. Funds are currently required to disclose before-tax returns reflecting the deduction of any fees and charges payable upon a sale of fund shares. While

these before-tax returns may usefully be compared to the proposed post-liquidation after-tax returns, they may not usefully be compared to the proposed pre-liquidation after-tax returns. Therefore, the SEC has proposed to require that funds also disclose before-tax returns that do not reflect the deduction of fees and charges payable upon a sale of fund shares. The proposal includes a number of assumptions that funds would be required to use to compute after- tax returns. Specifically, the proposal would require after-tax returns to be computed assuming that distributions and gains on a sale of fund shares are taxed at the highest applicable individual federal income tax rates.2 The proposal also would require funds to calculate after-tax returns for 1-, 5- and 10-year periods using the historical tax rates that were in effect during these periods. The proposed formulas would exclude state and local tax liability and would not reflect the impact of the alternative minimum tax or phaseouts of tax credits, exemptions and deductions for certain taxpayers. In addition, after-tax returns that appear in a fund's performance table in the risk/return summary would be calculated based on a calendar-year basis; after-tax returns that appear in the MDFP would be calculated on a fiscal-year basis. These measurement periods are consistent with those used for the before-tax return disclosures that currently appear in the risk/return summary and MDFP. The proposed after-tax return calculations would assume that any taxes due on a distribution are paid out of that distribution at the time the distribution is reinvested and would reduce the amount reinvested. The formulas would require that the taxable amount and tax character of each distribution be as specified by the fund on the dividend declaration date, adjusted to reflect subsequent characterizations. Finally, the proposal would require that post-liquidation after-tax returns be computed assuming a complete sale of fund shares at the end of the 1-, 5- or 10-year measurement period. In computing the taxes from any gain or the tax benefit from any loss, the rate used would be required to correspond to the tax character of the capital gain or loss (e.g., short-term or long-term). The tax character of the capital gain or loss would be determined by the length of the measurement period (1, 5 or 10 years) in the case of the initial $1,000 investment and the length of the period between the reinvestment and the end of the measurement period in the case of reinvested distributions. C. Narrative Disclosure The proposal would require funds to include a short, explanatory narrative adjacent to the performance table in the risk/return summary and the MDFP. The proposal would require the following information to be included in the narrative disclosure: ! the differences among the four types of return presented, including whether the returns reflect redemption and the charges and taxes associated with redemption; ! before-tax returns assume that all distributions are reinvested; ! the assumptions used in calculating after-tax returns; ! actual after-tax returns depend on an investor's tax situation and may differ from those shown; 3! the after-tax returns shown are not relevant to investors who hold their fund shares through tax-deferred arrangements; and ! after-tax returns reflect past tax effects and are not predictive of future tax effects. D. Exemptions The SEC has proposed to exempt money market funds from the requirement to disclose after- tax returns because the tax consequences of investing in different money market funds should be similar, i.e., current taxation on income distributions, and such a requirement could place money market funds at a competitive disadvantage vis-à-vis competing financial products. In addition, a fund that is offered as an investment option in a participant-directed defined contribution plan or variable insurance contract would be permitted to omit the after-tax return information in a prospectus for use by participants in the plan or owners of the contract. E. Compliance Date If the proposed after-tax return disclosure requirements are adopted, all new registration statements, post-effective amendments that are annual updates to effective registration statements, reports to shareholders and fund profiles filed six months or more after the effective date of the amendments would be required to comply with the proposed amendments. 4••• F. ••Comment Period • The SEC has requested comment on a broad range of issues relating to the proposed after-tax return disclosure requirements. Comments on the proposed amendments are due to the SEC by June 30, 2000. Amy B.R. Lancellotta Senior Counsel • Keith D. Lawson Senior Counsel Attachment