MEMO# 12173

July 5, 2000

INSTITUTE COMMENT LETTER ON SEC AFTER-TAX RETURNS PROPOSAL

[12173] July 5, 2000 TO: BOARD OF GOVERNORS No. 39-00 ACCOUNTING/TREASURERS COMMITTEE No. 26-00 SEC RULES COMMITTEE No. 95-00 TAX COMMITTEE No. 28-00 RE: INSTITUTE COMMENT LETTER ON SEC AFTER-TAX RETURNS PROPOSAL The Institute has filed a comment letter on the SEC's proposal to require funds to disclose after- tax returns.1 Overall, the Institute's letter supports the objectives of the Commission's proposals. The letter states, however, that the Commission's proposed approach has several shortcomings and, thus, recommends significant modifications to various aspects of the proposal. The Institute's letter is attached, and it is summarized below. 1. Location of the Required Disclosure The Institute's letter recommends that disclosure of after-tax returns be mandated in a fund's prospectus only, and not also in the Management's Discussion of Fund Performance ("MDFP"), which is typically contained in the annual report. The letter explains that this disclosure is more appropriate in the prospectus, and that requiring both documents to include after-tax returns would be inappropriate, unnecessary, and contrary to the Commission's long-standing philosophy favoring integrated disclosure. Moreover, the letter points out that including the disclosure in both documents could be confusing to investors because of the use of potentially different measurement periods (i.e., calendar year for the prospectus numbers and fiscal year for the MDFP numbers), and that the sheer volume of such disclosure would overwhelm the MDFP. The Institute's letter recommends that within the prospectus, after-tax return disclosure should be included in the tax section, rather than the risk/return summary as proposed. The letter explains that investors would benefit if all of the information about the tax consequences of investing in a fund were provided in one central location. In addition, because disclosure of after-tax numbers along with the required extensive narrative disclosure will be lengthy, including it in the risk/return summary would overwhelm other important information included in the summary. The Institute's letter supports the Commission's proposal to not require funds to include after-tax returns in fund advertisements and sales literature, unless they choose to do so (in which case they would be required to include after-tax returns computed in accordance with the proposed standardized formula). As an alternative, the letter states that the Commission could consider requiring funds to disclose that the performance data in sales materials do not reflect the impact of taxes, and that after-tax return information 1 See Memorandum to Board of Governors No. 15-00, Accounting/Treasurers Members No. 11-00, SEC Rules Members No. 19- 00 and Tax Members No. 11-00, dated March 21, 2000. 2is contained in the fund's prospectus. The letter recommends that in order to put claims of tax efficiency in proper perspective this aspect of the proposal should be modified in one respect; that is, to require funds to include after-tax returns in sales materials in which a before-tax return is accompanied by a claim of "tax efficiency." 2. Required After-Tax

Return Numbers The Institute’s letter supports two types of after-tax numbers – “pre-liquidation” and “post- liquidation” returns – in order to provide a balanced and meaningful presentation. The letter, however, opposes the Commission’s proposal to require three new sets of numbers – two after-tax numbers (one that assumes a fund’s shares are held through the reporting period and one that assumes they are redeemed at the end of the period) and one new before-tax number (that does not reflect the deduction of any contingent deferred sales charges (“CDSCs”) or redemption fees). The letter recommends that the Commission should instead adopt the alternative approach discussed in its proposing release, in which the “pre-liquidation“ after-tax numbers would reflect the deduction of any CDSCs and redemption fees. This approach would eliminate the need for the proposed new before-tax number, the purpose of which is to provide investors with comparison to the pre-liquidation after-tax number. The letter adds that any potential confusion that might result from this approach can be addressed by revising the captions in the proposed standardized table and through appropriate narrative disclosure. The letter also recommends that in order to avoid inundating investors with numbers, a multiple class fund should be permitted to disclose after-tax returns for only one class, rather than for all classes offered by the prospectus. 3. Standardized Formula for Computing After-Tax Returns The letter supports many aspects of the Commission’s proposed formula but strongly opposes the use of the highest marginal tax rate. The letter recommends instead the use of marginal federal ordinary income and long-term capital gains tax rates that are more representative of the average fund investor’s tax situation. Specifically, the letter proposes that the federal tax rates be the historic tax rates for ordinary income and long-term capital gains applicable to investors (married filing jointly) with taxable income of $55,000. The letter also recommends that the formula be changed so that all hypothetically redeemed shares are treated as generating long-term capital gains (or losses). 4. Exemptions From the Disclosure Requirement The Institute’s letter supports the Commission’s proposal to exempt from the disclosure requirement money market funds and the prospectuses of those funds that offer their shares as investment options for defined contribution plans, tax-deferred arrangements, variable insurance contracts, and similar plans and arrangements. The letter recommends that the Commission also exempt bond funds. The letter explains that investors generally purchase bond funds to receive current distributions of income, which will be tax-exempt or taxable depending on the type of fund purchased, and that because these investors understand the tax consequences of the periodic distributions they receive, after-tax returns disclosure is not necessary for them. The Institute recommends that if the Commission is unwilling to exclude all bond funds from the proposal, then, at the very least, the Commission should exclude tax-exempt bond funds from the proposed disclosure requirement. This exemption is appropriate because periodic distributions by a tax-exempt bond fund generally will be exempt from tax, resulting in minimal tax consequences for investors in such a fund. 5. Compliance Date 3The Institute’s letter disagrees with the Commission’s proposal to require all new registration statements, post-effective amendments that are annual updates to effective registration statements, reports to shareholders, and profiles filed six months or more after the effective date of the amendments to comply with the proposed amendments. The letter explains that a six-month time frame would be inadequate in most circumstances and recommends instead a twelve-month transition period. The letter notes, however, that a six-month transition period would be appropriate for funds that include after-tax returns in advertisements and sales literature. The letter also recommends that the Commission clarify in its adopting release that funds will be permitted to file post-effective amendments with the new disclosure under Rule 485(b) of the Securities Act, if otherwise eligible to do so under the rule. 6. Need for the Commission to Re-Evaluate Rules If Tax Law is Changed The Institute’s letter makes clear that the SEC should reconsider the after-tax return disclosure requirement if the current tax regime applicable to mutual fund shareholders changes. The letter notes that there are legislative 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. The letter cautions that if any proposals along these lines are enacted, the proposed after-tax returns disclosure will have little relevance. Barry E. Simmons Assistant Counsel Attachment Attachment (in .pdf format)
