

MEMO# 7663

February 26, 1996

POSSIBLE RECOMMENDATION TO REVISE TREATMENT OF TAX EXEMPT MARKET DISCOUNT BONDS UNDER MUTUAL FUND YIELD FORMULA

1 SEC Release Nos. 33-7243; IC 21538 (November 22, 1995). 2 In a 1989 submission to the Division of Investment Management, the Institute proposed that tax exempt UITs be permitted to quote either: (1) a pure tax free yield; or (2) a yield including market discount, accompanied by disclosure of the portion of that yield that could be subject to federal income tax or by the pure tax free yield. The Institute recommended that tax exempt mutual funds be accorded the same treatment. Based on the pending UIT yield proposal, it appears that the SEC is not inclined to follow this proposed approach. February 26, 1996
TO: SEC RULES COMMITTEE No. 14-96 RE: POSSIBLE RECOMMENDATION TO REVISE
TREATMENT OF TAX EXEMPT MARKET DISCOUNT BONDS UNDER MUTUAL FUND YIELD
FORMULA _____ As

you may know, the Securities and Exchange Commission recently proposed a uniform yield formula for unit investment trusts.¹ In many respects, the proposal is based on proposals made by the Institute, which, in turn, are based on the SEC's mutual fund yield formula. The Institute has been working with a subcommittee of its Unit Investment Trust Committee on a draft comment letter responding to the proposal. In connection with that effort, an issue has arisen regarding the appropriate treatment of tax exempt market discount bonds -- in the case of both UITs and mutual funds -- for purposes of calculating yield. Specifically, both the mutual fund yield formula and the proposed UIT yield formula provide that the accretion of market discount is excluded from yield, because it is not exempt from federal income tax.² The Institute's UIT Yield Subcommittee has recommended that the Institute urge the SEC to revise the proposed UIT yield formula to include market discount, but on an after-tax basis (i.e., the portion of the yield representing market discount would be reduced by applying the highest marginal tax rate to it). Arguably, this "after-tax" yield would provide investors with a more accurate estimation of the yield they can expect to realize. If the Institute takes this position with respect to UITs, we would recommend a similar change to the mutual fund yield formula. It should be noted that, in a rising interest rate environment, the proposed change could result in materially higher yields for tax free mutual funds. On the other hand, the proposal could have certain negative consequences. For example, it is possible that the SEC would require substantial additional disclosure to accompany such a yield quotation. In addition, some members have expressed concern that the SEC would not allow such a yield quotation to be characterized as "tax free." Finally, if the Institute were to recommend this change to the mutual fund yield formula, it could provide an opportunity

for the SEC to revisit other provisions of the formula -- such as the compounding element. In light of these and any other possible implications, we would appreciate your comments on whether the Institute should pursue the ability for tax exempt mutual funds to quote an "after-tax" yield. This matter will be considered by the Institute*s Executive Committee at its meeting on March 7th. In order that the views of SEC Rules Committee members may be reported at that meeting, please call me at (202) 326-5822 with any comments by Monday, March 4th. Frances M. Stadler Associate Counsel

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