

MEMO# 11383

November 3, 1999

HOUSE SUBCOMMITTEE APPROVES H.R. 1089; INSTITUTE TESTIFIES ON AFTER-TAX DISCLOSURE OF FUND RETURNS

1 See Memorandum to the Board of Governors No. 23-99, Federal Legislation Members No. 10-99, Primary Contacts - Member Complex No. 34-99, Public Information Committee No. 12-99, SEC Rules Committee No. 23-99, and Tax Committee No. 6-99, dated March 31, 1999. 1 [11383] November 3, 1999 TO: BOARD OF GOVERNORS No. 69-99 FEDERAL LEGISLATION MEMBERS No. 24-99 PRIMARY CONTACTS - MEMBER COMPLEX No. 97-99 PUBLIC INFORMATION COMMITTEE No. 45-99 SEC RULES COMMITTEE No. 91-99 TAX COMMITTEE No. 30-99 RE: HOUSE SUBCOMMITTEE APPROVES H.R. 1089; INSTITUTE TESTIFIES ON AFTER-TAX DISCLOSURE OF FUND RETURNS

On November 2, the House Commerce Subcommittee on Finance and Hazardous Materials approved H.R. 1089, the "Mutual Fund Tax Awareness Act of 1999." 1 The bill directs the U.S. Securities and Exchange Commission (SEC) to adopt a rule within 18 months after the enactment of the bill to require mutual funds to disclose the effects of taxes on returns to fund investors. H.R. 1089 now moves to the full Commerce Committee, which is expected to report the bill in the near future. On October 29, the subcommittee held a hearing on "Increasing Disclosure to Benefit Investors." Testifying before the subcommittee on H.R. 1089 were Institute President Matthew P. Fink, Joel Dickson, Senior Investment Analyst of The Vanguard Group, and David Jones, Vice President of Fidelity Management & Research Company. In his opening remarks, the bill's author, Rep. Paul Gillmor (R-OH), praised the industry for its support of "enlightened disclosure." The following summarizes the testimony of the witnesses and the SEC's submitted statement. Copies of the full statements are attached. Institute Testimony The Institute supported the bill's objective that the SEC should develop improved disclosure about the effect of taxes on a mutual fund's performance. "Mutual fund shareholders who have taxable accounts need to understand the impact that taxes can have on the returns generated by their investments," the statement said. "Indeed, ensuring a strong understanding of the tax consequences of fund investing is entirely consistent with the Institute's long-standing support for initiatives to improve disclosure to investors." 2 The Institute noted that it has been working with the bill's sponsors and the SEC. A threshold matter that the SEC will have to resolve is whether it would be best to expand upon the existing required tax-related disclosures in prospectuses and shareholder reports, or to require funds to calculate one or more after-tax return numbers. The statement stressed that any after-tax return numbers should be accompanied by textual disclosure that informs investors of their appropriate use and inherent limitations; otherwise, investors could misunderstand them and even be misled. In

closing, the Institute supported the bill's approach, which mandates the SEC to fashion the new disclosure requirements through regulatory action instead of federal legislation. The Institute said it would continue to work with Congress and the SEC to achieve a result that will be most useful to mutual fund shareholders. Testimony of The Vanguard Group Joel Dickson, Senior Investment Analyst of The Vanguard Group, also supported the objectives of H.R. 1089. He said that taxes are the largest cost of mutual fund investment for most investors, and funds vary tremendously in the tax burdens they place on their shareholders. Dickson noted Vanguard's recent decision to start reporting after-tax returns in the annual reports of all of their balanced and equity mutual funds. Testimony of Fidelity Research & Management Company David Jones, Vice President of Fidelity Management & Research Company, also supported the goal of H.R. 1089. Jones said that investors would benefit from a better understanding of the impact of taxes on their investments, and from the development of an industry-standard calculation allowing comparisons across different funds. He noted that the hearing and the legislation provide a good starting point in developing an industry standard. He added that the issues are complex and details will need to be decided by the SEC, the industry and other interested groups in collaboration. SEC Statement The SEC reported that the staff is considering whether there are measures of disclosure—other than the ones currently required—that could be used to convey mutual fund tax consequences that are understandable to investors and not unduly burdensome for funds to compute. According to the statement, the SEC staff's considerations have focused on two measures: pre-liquidation after-tax return and post-liquidation after-tax return, or a combination of the two. 3The SEC said that staff is currently preparing a recommendation that the SEC issue proposed rule amendments intended to improve the disclosure of tax consequences of mutual fund investments. The proposed rule amendments would be the subject of public notice and comment. * * * * * We will keep you informed of further developments. Matthew P. Fink President Attachments

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