

**MEMO# 11917**

May 30, 2000

## **DRAFT COMMENT LETTER ON SEC AFTER-TAX RETURNS RULE PROPOSAL**

1 See Memorandum to SEC Rules Committee No. 44-00 and Tax Committee No. 11-00, dated March 21, 2000. [11917] May 30, 2000 TO: SEC RULES COMMITTEE No. 81-00 TAX COMMITTEE No. 25-00 RE: DRAFT COMMENT LETTER ON SEC AFTER-TAX RETURNS RULE PROPOSAL \_\_\_\_\_ As we previously informed you,<sup>1</sup> the SEC has proposed rule and form amendments that would require funds to disclose after-tax returns. The Institute has prepared a draft letter in response to the SEC's proposal. A copy of the letter is attached and it is summarized below. Comments must be filed with the SEC by June 30th. The Institute has scheduled a meeting for June 8, 2000 to discuss the draft letter. The meeting will be held at 10:00 a.m. at the Institute, in the David Silver Conference Room on the 12th Floor. Please contact Stephanie Holly at (202) 326- 5814 to let her know whether you will be attending the meeting, if you have not already done so. If you will be unable to attend the meeting but would like to provide comments on the Institute's draft letter, please contact any of the following Institute staff by Thursday, June 8th. Please note that we plan to circulate another draft letter shortly after the June 8th meeting. phone fax email Amy B.R. Lancellotta (202) 326-5824 (202) 326-5827 amy@ici.org Keith D. Lawson (202) 326-5832 (202) 326-5841 lawson@ici.org Barry E. Simmons (202) 326-5923 (202) 326-5827 bsimmons@ici.org

Summary of the Institute's Comments The Institute's draft letter supports the objectives of the Commission's proposals – to improve “after-tax” disclosure to investors. The letter expresses concern, however, that the Commission's after- tax returns proposals, as drafted, would not provide investors with prospectus disclosure that presents clear, concise and understandable information about an investment in a fund. The letter recommends a series of modifications that are needed including the following that are of particular importance. ! First, disclosure of after-tax returns should be mandated in a fund's prospectus only, rather than also in the MDFP. The letter explains that there is no reason to provide this disclosure in two separate documents and notes that it is more appropriate in the prospectus, to assist investors in making an investment decision about the fund. In addition, the sheer volume of the disclosure would overwhelm the MDFP in the annual report. ! Second, within the prospectus, after-tax return disclosure should be included in the tax section of the prospectus, rather than the risk/return summary. The letter notes that investors would benefit if all of the tax information about 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. ! Third, the proposed standardized formula for computing the after-tax return number should reflect tax rates for ordinary income and capital gains that are representative of the rates paid by average fund investors, rather than the maximum federal tax rate. Using the highest rate would be

misleading to many investors because it would grossly overstate the impact of taxes on them. The draft letter comments on other aspects of the Commission's proposals as follows:

**Required After-Tax Numbers** The Institute's letter supports the Commission's proposal to present both "pre-liquidation and "post-liquidation" after-tax returns, but does not support the Commission's proposal to require disclosure of four types of return. Rather, the letter notes that requiring four sets of performance numbers will result in "information overload" and that the use of a "pre-liquidation before-tax" performance number would inappropriately create competitive disadvantages between funds with front- end loads and funds with contingent deferred sales charges. The letter recommends, therefore that the proposal be modified to require that "pre-liquidation" after-tax returns reflect the deduction of any exit fees and to eliminate the requirement that funds disclose before-tax returns that do not reflect these fees. The letter recommends that in order to address any possible confusion regarding the first set of after-tax return numbers, the Commission should revise the proposed captions to read as follows:

! Impact of taxes on fund distributions ! Impact of taxes on fund distributions and sale of fund shares

**Standardized Formula For Computing After-Tax Returns** The Institute's letter comments on the Commission's proposed formula for computing after-tax returns. Specifically, the letter recommends that: (1) the formula use the more representative marginal federal ordinary income and long-term capital gains tax rates that apply to investors (married filing jointly) with taxable income of \$55,000; (2) the formula not reflect the impact of either the alternative minimum tax or the phase-outs of itemized deductions and personal exemptions; (3) the formula not attempt to adjust for widely varying state and local taxes; (4) historic tax rates be used to calculate after- tax returns; (5) the formula reduce the reinvested dividend amount to reflect the tax applicable to the distribution; (6) the taxable amount and character of each distribution to be treated as specified by the fund on the dividend declaration date, adjusted to reflect subsequent recharacterizations; (7) all hypothetically-redeemed shares be treated as generating long-term capital gains or losses; and (8) any redemption loss offset a corresponding amount of capital gain from unrelated transactions.

**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 prospectus of funds that are offered as an investment option 3 in (1) any retirement plan pursuant to which an investor is not taxed until the investment is sold or (2) a variable insurance contract ("tax-deferred plans"). The letter also recommends that the Commission exempt from the rule all bond funds, specifically, any fund that invests a certain percentage of its assets in bonds and distributes significantly all of the interest income on its bond portfolio at least monthly. The letter explains that capital gain distributions by bond funds tend to be fairly uniform and that unlike equity funds, where portfolio managers may actively trade securities based upon projections of future increases or decreases in value, bond fund managers typically dispose of securities only (1) because of concerns about deteriorating credit quality, (2) to move along the yield curve or (3) to meet shareholder redemptions. None of these three factors is likely to have any significant impact on the relative performance of funds on an after-tax basis.

**Compliance Date** The draft letter recommends that the proposed six month transition date be extended to twelve months after the effective date of the amendments. In addition, the letter recommends that in order to reduce certain administrative burdens, the Commission should permit a fund complex to file a registration statement under the amended rules pursuant to Rule 485(a) of the Securities Act of 1933 for a single fund in the complex that contains the requisite disclosure that would be representative of the disclosure that would be contained in the prospectuses of the other funds in the complex.

Barry E. Simmons Assistant Counsel Attachment

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