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Comment Letter on SEC After-Tax Returns Proposal, July 2000

June 30, 2000

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Disclosure of Mutual Fund After-Tax Returns
(File No. S7-09-00)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposed rule and form amendments under the Securities Act of 1933 and the Investment Company Act of 1940 that would require mutual funds to disclose after-tax returns based on standardized formulas.[2]

I. Introduction And Summary Of Comments

The Institute supports the objectives of the Commission's proposals—to improve "after-tax" disclosure to investors.[3] Mutual fund shareholders should understand the impact that taxes can have on returns generated in their taxable accounts and be able to make meaningful comparisons among funds on this basis. Indeed, enhancing investor understanding in this area is entirely consistent with the Institute's long-standing support for initiatives that improve disclosure to investors.

Mutual funds are already required to disclose significant information about taxes to investors. Under the Commission's proposals, funds would also be required to provide investors with after-tax numbers. We recognize that there are certain benefits to this approach. In particular, providing standardized numbers would facilitate the ability of shareholders to compare the effects of taxes on the performance of different funds. This approach also would not require a shareholder to review financial statements and apply the correct tax rates to determine the effects of taxes upon his or her return.

On the other hand, there are significant shortcomings to after-tax numbers. In order to compute after-tax numbers, funds will have to make a series of assumptions, many of which will not be applicable to any particular shareholder. Thus, the numbers could be misleading and confusing because they often will not reflect a fund shareholder's own individual circumstances. In addition, investors may view these numbers as predictive and make inappropriate investment decisions. Finally, to ensure that investors understand all of their inherent limitations, after-tax numbers will have to be accompanied by narrative disclosure that may be technical and lengthy.

Nevertheless, despite these rather significant issues, it is our view that, on balance, providing investors with after-tax numbers could enhance their understanding of the impact of taxes on fund performance and permit investors to compare the varying impact of taxes on otherwise comparable funds. As discussed below in Section VIII, however, this view is contingent on the current tax regime for mutual funds and their shareholders remaining essentially unchanged.

Crafting and implementing effective disclosure rules that provide investors with meaningful after-tax return information is a challenging task. In addition, in view of the fact that this proposal is the most significant disclosure initiative undertaken by the Commission since the adoption of sweeping amendments to Form N-1A,[4] it is important that any new disclosure requirements not undermine the important objectives of those amendments—to provide investors with disclosure that presents clear, concise and understandable information about an investment in a fund.

Unfortunately, we believe that certain aspects of the Commission's proposals would be contrary to those objectives, as they would require the disclosures to be made in a manner that could be misleading and overwhelm other important information. Accordingly,

the Institute believes that significant modifications are needed. Four changes are particularly important:

- First, disclosure of after-tax returns should be mandated in a fund's prospectus only, rather than also in the Management's Discussion of Fund Performance ("MDFP"), which is typically included in a fund's annual report. It is neither necessary nor appropriate to include the disclosure in both the prospectus and the annual report. Doing so would be contrary to the Commission's long-standing philosophy favoring integrated disclosure. In addition, disclosing this information 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). The disclosure is more appropriate in the prospectus, where it can assist investors in making an investment decision about the fund. In contrast, the annual report is designed primarily for existing shareholders, who already receive personalized year-end tax information. Moreover, the sheer volume of the disclosure would overwhelm the MDFP.

- Second, within the prospectus, after-tax return disclosure should be included in the tax section, rather than the risk/return summary. 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 Commission should not require three new sets of numbers—two after-tax and one new before-tax. Instead, the Commission should adopt the alternative approach discussed in the Proposing Release, which would eliminate the need for new before-tax numbers and require both sets of after-tax numbers to reflect the deduction of any fees and charges payable upon a sale of fund shares. In addition, a multiple class fund should be required to disclose after-tax returns for only one class, rather than for all classes offered by the prospectus. Otherwise, investors will be unnecessarily inundated with numbers.

- Fourth, 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.

Each of these recommendations is discussed below. In addition, we have comments on a number of other aspects of the proposals. Our comments address, in turn: (1) the location of the required disclosure; (2) what types of after-tax return numbers should be required; (3) the contents of the narrative disclosure; (4) the standardized formula for computing after-tax returns; (5) exemptions from the disclosure requirement; (6) the compliance date; and (7) the need for the Commission to re-evaluate any rules it adopts in this area if Congress enacts legislation that would significantly change the way fund shareholders are taxed.

II. Location Of The Required Disclosure

A. Prospectus/Annual Report

The Commission's proposals would require funds to disclose after-tax returns both in their prospectuses and in their MDFPs. For the reasons discussed below, after-tax returns should be mandated in a fund's prospectus only, and not in the MDFP.

It is neither necessary nor appropriate to include after-tax return information in both the prospectus and the MDFP. While taxes are an important consideration for investors purchasing fund shares in their taxable accounts, they are not so important relative to other factors that they need to be included in two disclosure documents provided to shareholders.

The Commission's proposal also would run contrary to the philosophy of integrated disclosure. The goal of the SEC's integrated disclosure system is "to revise or eliminate overlapping or unnecessary disclosure and dissemination requirements wherever possible, thereby reducing burdens on registrants while at the same time ensuring that security holders, investors and the marketplace have been provided with meaningful nonduplicative information upon which to base investment decisions."[5]

In addition, disclosing after-tax numbers in the prospectus and the MDFP could result in investor confusion. While the after-tax information in the prospectus would be computed on a calendar year basis (which is the period over which the tax liability of most shareholders is calculated), in the MDFP it would be computed based on a fund's fiscal year. In those instances where a fund has a different measurement period for its prospectus and annual report (a common occurrence), presenting two sets of after-tax returns with different numbers could confuse investors. Having to explain and reconcile the difference would only add to the already lengthy disclosure that would already be generated by this proposal.

Finally, we note that legislation passed by the House to direct the Commission to require funds to disclose after-tax numbers explicitly states that the disclosure should be in the prospectus or annual report.[6] As initially introduced, this legislation would have required the numbers in both documents but was subsequently amended.[7]

Clearly, the prospectus, which is intended "to allow investors to make better informed [investment] decisions,"[8] is the more appropriate document for this disclosure. In contrast, while many funds provide their annual reports to prospective investors, annual reports are designed and intended primarily for existing shareholders. It is doubtful that these existing shareholders would choose to rely on after-tax return disclosure in the MDFP to evaluate the tax consequences of investing in a fund. Investors who already own

shares in a fund have the ability to ascertain their own individual tax consequences by using the Internal Revenue Service Forms 1099 they receive from the fund at the end of each year. In contrast, the standardized after-tax return number would be no more than an estimate that is based on a variety of factors and assumptions, many of which are not likely to even apply to a particular shareholder's circumstance. It thus would provide little, if any, additional useful information to existing fund shareholders.

Moreover, calendar year calculations facilitate fund comparisons. Pursuant to the excise tax distribution requirements of the Internal Revenue Code, all funds effectively are required to distribute essentially all of their income in the calendar year in which it is received.[9] Thus, return calculations based upon calendar years will uniformly measure the impact of taxes on distributions made by different funds. Fiscal year calculations, in contrast, make these comparisons difficult. First, as funds are permitted by Subchapter M to distribute their fiscal year income following the close of the fiscal year, any after-tax calculation for a fiscal year may not reflect the tax consequences of the fund's return for that fiscal year. Second, as funds have significant flexibility in determining the timing of their fiscal year distributions, the potential would exist for timing distributions to affect after-tax performance.[10]

Finally, including after-tax returns in the MDFP would overwhelm the other information presented. The MDFP discusses those factors, strategies, and techniques that materially affected the fund's performance during its past fiscal year. Typically, this discussion is relatively brief and concise. Lengthy disclosure of after-tax returns would inappropriately dominate the MDFP discussion.

B. Location Within the Prospectus

Under the Commission's proposal, a fund would be required to disclose after-tax returns in the performance table contained in the risk/return summary of the prospectus. We strongly disagree that the risk/return summary is an appropriate location. Instead, the disclosure should be included in the tax section of the prospectus.[11]

The Commission recognizes that the tax section of the prospectus "could provide a centralized location for tax information."[12] We agree, and note further that investors would be best served if all relevant tax information were presented in one place. In order for investors to fully understand the information being conveyed by an after-tax return presentation, they need to first understand the basic tax consequences of investing in a fund. These include, for example, that distributions received from the fund are subject to taxes and that shareholder redemptions may result in a gain or loss for tax purposes. This discussion should precede any after-tax return presentation in order to maximize investor understanding.

In addition, the inclusion of after-tax numbers and accompanying narrative disclosure in the risk/return summary would overwhelm the other important information included in the summary. The proposed presentation would require after-tax numbers for 1-, 5-, and 10-year periods on both a pre-liquidation and post-liquidation basis, along with a new before-tax number—nine new numbers for a single class fund and many more in a prospectus offering several different funds or a single fund with multiple classes.[13]

The proposed presentation also would require the inclusion of narrative disclosure adjacent to the performance table. We agree that narrative disclosure that informs investors of the appropriate use and inherent limitations of after-tax numbers is necessary. It is critical, for example, that investors understand that the numbers probably will not reflect the investor's own individual circumstances. Investors also must be aware that certain of the numbers are based on the assumption that the investor will redeem his shares at fixed points in time (i.e., 1-, 5-, and 10-year periods), which will probably not be the case. Moreover, it is important that investors understand the significant "predictive" limitations of after-tax return numbers. Based on the foregoing, we disagree with the Commission's determination that the narrative disclosure would be short; it will inevitably be lengthy. In contrast, almost no narrative disclosure is required in connection with before-tax returns. [14]

Moreover, the proposed disclosure will not be applicable to all investors in a fund.[15] While before-tax return information applies to all investors, and thus is appropriate for inclusion in the risk/return summary, after-tax return information would not apply to all investors. For example, it would not be applicable to investors that hold their mutual funds in a tax-qualified account, such as a qualified employer-sponsored retirement plan or an Individual Retirement Account.[16] Similarly, even for those taxable investors for whom after-tax information may be relevant, the numbers calculated would not necessarily reflect any particular individual's tax consequences of investing. Disclosure that has only limited applicability does not belong in the risk/return summary.

For all of these reasons, it would be more appropriate to include after-tax return information in the tax section of the prospectus rather than the risk/return summary. Instead, funds simply should be required to disclose in their risk/return summary that the performance data does not reflect the impact of taxes, and that after-tax return information is contained in the tax section of the prospectus. Moreover, the tax section should not be required to repeat the before-tax returns that appear in the risk/return summary. Disclosing after-tax returns by themselves would make the presentation simpler and, thus, easier for investors to understand. Furthermore, as noted, the purpose of moving the after-tax returns to the tax section would be to centralize the tax disclosure in the prospectus. Before-tax returns would not be relevant to that disclosure.[17]

On a different but related point, we note that the proposal to require funds to disclose after-tax returns in the risk/return summary would have the effect of requiring fund profiles to include after-tax returns because a profile must include the prospectus risk/return

summary. For the same reasons that after-tax returns are inappropriate for the risk/return summary, they should not be required in fund profiles. Rather than requiring this overwhelming disclosure in a fund's profile, the Commission should maintain the current reporting scheme of disclosing before-tax return information but require disclosure to the effect that the performance data does not reflect the impact of taxes, and that after-tax return information is contained in the fund's prospectus. Should the Commission nevertheless determine to require disclosure of after-tax returns in fund profiles, for the reasons discussed above, that disclosure should not be included in the risk/return summary.

C. Advertisements and Sales Literature

Under the Commission's proposal, funds would not be required to include after-tax returns in fund advertisements and sales literature; however, any fund choosing to include after-tax returns in these materials would have to compute the returns in accordance with the proposed standardized formula.

The Institute supports the approach the Commission has taken in the proposal. As indicated, it will be necessary to accompany after-tax return numbers with fairly extensive disclosure. Such disclosure simply will not be feasible in most advertisements and sales literature. As an alternative, the Commission could consider requiring funds to disclose that the performance data in such materials does not reflect the impact of taxes, and that after-tax return information is contained in the fund's prospectus.

The Institute does recommend one modification to the proposal. The SEC should require funds to include after-tax returns in advertisements and sales literature in which a before-tax return is accompanied by a claim of "tax efficiency." For example, a fund advertising a 20 percent total return and claiming 100 percent tax efficiency should be required to show standardized after-tax returns. Such disclosure is needed in order to put claims of tax efficiency in proper perspective; for example, a fund that has made no taxable distributions could claim "100 percent tax efficiency," but have significant unrealized gains that would result in tax liabilities to investors when those gains are realized and distributed, or when an investor redeems his or her shares. [18]

III. Required After-Tax Return Numbers

Under the Commission's proposals, funds would be required to compute three new sets of total return numbers. First, funds would have to compute two sets of after-tax return numbers—one that assumes their shares are held through the end of the reporting period and one that assumes that they are redeemed at the end of the period. In addition, funds would have to compute a new set of before-tax numbers, which would not reflect costs incurred as a result of redemptions, such as contingent deferred sales charges ("CDSCs") and redemption fees. The purpose of the new before-tax return is to provide investors with a comparison to the pre-liquidation after-tax number.[19] All three sets of numbers, together with the currently required before-tax numbers, would have to be presented for each fund, and each class of a fund, offered in a prospectus.

The Institute believes that the Commission's proposal would result in disclosure too voluminous to be of any practical use to most investors. We strongly recommend that it be simplified, and believe that it can be without reducing the quality of the information that would be provided. In particular, we recommend that, in lieu of the "four number" approach, the Commission instead adopt the alternative approach set forth in the Proposing Release, in which the "pre-liquidation" after-tax numbers would reflect CDSCs and redemption fees and no additional before-tax numbers would be required.[20] We believe that any potential confusion that might result from this approach can be addressed by changing the captions in the table and through appropriate narrative disclosure. At the same time, the disclosure overall would be greatly improved, as it would be simpler and more directly focused on presenting the effects of taxes on returns. For similar reasons, we also recommend that the Commission not require after-tax numbers to be presented for every class in a multiple class fund, but instead only for a single representative class.

Each of these points is discussed below, as is our response to the SEC's request for comment on the advisability of an index or peer group comparison. In order to highlight the benefits of our approach, we have attached sample tables prepared in accordance with the SEC's proposals (Attachment A) and in a manner that reflects our recommendations (Attachment B).

A. After-Tax Numbers

As noted above, the Commission's proposal contemplates funds disclosing four types of returns for 1-, 5- and 10-year periods:

The Institute supports requiring two types of after-tax numbers, as each type provides important information. "Pre-liquidation" returns focus on the effects of taxes resulting from the portfolio manager's investment decisions. "Post-liquidation" returns also reflect the impact that taxes can have when fund shares are sold (i.e., the impact of taxes on unrealized appreciation in the fund's portfolio and realized but undistributed income and capital gains). Disclosure of just one type of after-tax return could distort the presentation. A "pre-liquidation" number alone understates an investor's total potential tax exposure because it omits the tax effects of redeeming out of a fund; in contrast, a "post-liquidation" number alone overstates the impact of taxes because it assumes that the investor will redeem his or her shares at the end of the measurement period, which will probably not be the case. Accordingly, in order to provide a more balanced and meaningful presentation, both types of numbers should be disclosed.

Nevertheless, the Institute does not support the Commission's proposal to require disclosure of four types of return. We believe that requiring four sets of performance numbers will result in "information overload" and only discourage most investors from making use of the disclosure. We particularly object to requiring an additional set of before-tax numbers; the current requirements governing standardized performance numbers have worked well since their adoption in 1988 and have come to be accepted as the primary means to evaluate and compare fund past performance. We do not believe it would be wise to upset this. Among other things, the use of a "pre-liquidation" before-tax performance number would result in funds (or classes) with front-end loads inappropriately reporting lower returns than funds (or classes) with CDSCs.[21]

Accordingly, the Institute recommends 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. Such a change would greatly simplify after-tax returns disclosure to the benefit of fund investors.[22] In addition to reducing the sets of numbers that would be required, this approach would isolate the impact of taxes that result from fund distributions and shareholder redemptions, thereby clarifying the differences between the two after-tax numbers (i.e., the impact of taxes on redemption). This will allow investors to better understand this new and complex information, without having to take into account other extraneous factors.

In order to address any possible confusion regarding the first set of after-tax return numbers, the Commission should revise the proposed captions in the table to read as follows:

- Returns after taxes on fund distributions
- Returns after taxes on fund distributions and sale of fund shares

In addition, funds should be required to explain in the accompanying narrative that the first set of numbers does not reflect taxes that would be incurred upon redemption at the end of the periods, although it does reflect (if applicable) any CDSCs or redemption fees.

B. Multiple Class Funds

Under the proposal, funds would be required to show after-tax returns for all classes offered by the prospectus. We oppose this requirement. Instead, a multiple class fund should be required to show after-tax returns for only one class. Otherwise, investors will be unnecessarily inundated with numbers. A fund that offers three classes of shares, for example, would have to present 27 new numbers (36 in total) under the Commission's proposal—a daunting and potentially confusing, if not incomprehensible, presentation. Even our simplified proposal would require 18 new numbers for that fund. If after-tax returns were required for only one class, then only 6 new numbers would be necessary.

In view of the fact that the numbers are based on assumptions that may not be applicable to any individual investor but rather are intended merely to illustrate the impact of taxes on a fund's performance, there is no need to disclose after-tax numbers for all classes offered through a fund's prospectus.[23] In fact, providing numbers with such a degree of specificity could mislead an investor about the reliability of the numbers as they relate to his own circumstances.

We note that there is precedent for our recommendation. A multiple class fund is required to include information about only one class in the bar chart in the risk/return summary. This requirement has served investors well in that the bar chart is fairly simple and easy to understand, which would not be the case if it were required to reflect all classes. The same methodology used for selecting the class shown in the bar chart should be used for selecting which class to reflect in the after-tax returns table. This methodology permits a fund to choose the class, subject to certain limitations. In particular, the class selected must have returns for at least 10 years or, if the classes all have fewer than 10 years of returns, the class that has returns for the longest period must be selected.[24] With respect to the after-tax returns table, a fund should be permitted to select only a class that will be offered as an investment in taxable accounts. We would recommend that a fund that includes after-tax returns for only one class be required to explain in the accompanying narrative disclosure that the returns are for only one of the classes offered by the prospectus (and identify which class) and that the returns for the other classes will vary.[25]

C. Index Comparison

The Commission requested comment on whether disclosure of after-tax returns for an index or a peer group of funds should be required.[26] The Institute would strongly oppose any such requirement. There currently are no appropriate indexes against which to compare the after-tax returns of most funds and we would question the reliability of after-tax numbers of a peer group of funds for those periods prior to the adoption of the Commission's proposal. Moreover, any benefit of such disclosure would be outweighed by the risk of overloading investors with too many numbers. The inclusion of yet another set of numbers would surpass the point of diminishing returns.

IV. Narrative Disclosure

The Commission's proposal would require funds to include a "short, explanatory" narrative (in plain English) adjacent to the performance table. Funds would have the flexibility to craft their own narrative disclosure. The Institute generally supports this proposal. We agree that it is essential that after-tax returns be accompanied with appropriate narrative disclosure to ensure investor understanding of these numbers. We have two technical suggestions to improve the disclosure to better achieve the objectives of facilitating understanding.

First, we recommend eliminating the disclosure that before-tax returns assume that all distributions are reinvested.[27] Second, we recommend eliminating the disclosure that after-tax returns assume that taxes are paid out of fund distributions and that distributions, less taxes, are reinvested.[28] This information, which simply concerns the details of how the numbers are calculated, is not essential to an investor's understanding of the after-tax return numbers. Moreover, it seems odd that the Commission is proposing to require new disclosure relating to before-tax returns, which are already disclosed in the prospectus.

V. Standardized Formula For Computing After-Tax Returns

The Commission's proposal would require funds to compute after-tax returns using standardized formulas that are based largely on the current standardized formula for computing before-tax average annual total return. After-tax returns would be computed assuming a hypothetical $1,000 one-time initial investment and the deduction of the maximum sales load and other charges from the initial $1,000 purchase. Funds would be required to use several other assumptions, which are noted below.

The Institute supports many aspects of the proposed formula. We strongly oppose, however, the use of the highest marginal tax rate in the formula. Instead, a rate that is more representative of the typical fund investor should be used. We also recommend that the formula be changed so that all hypothetically-redeemed shares be treated as generating long-term capital gains (or losses). These and other points are discussed below.

A. Tax Rate

The Commission has proposed that the highest individual marginal federal income tax rates—currently 39.6 percent for ordinary income and short-term gains and 20 percent for long-term capital gains—be applied to income and gains arising from the hypothetical $1,000 investment. We strongly disagree with this approach because, as demonstrated below, it would significantly overstate the tax consequences of investing for most fund shareholders.

Instead, the Commission should use 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 Institute 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.[29] For calendar year 1999, the tax rates applicable to married filing jointly taxpayers with $55,000 of taxable income were 28 percent for ordinary income[30] and 20 percent for long-term capital gains.[31] In future years, the rates could be determined from readily-available IRS documents (including the IRS' internet web site)[32] and would be widely known by fund companies and third parties calculating after-tax returns. Thus, there would be no need for the Commission each year to announce the applicable tax rates for ordinary income and long-term capital gains.

The underlying assumption in our proposal—that the average fund shareholder has $55,000 of taxable income—is a conservative one. Our proposal is based upon 1999 data, which indicates that the gross (rather than taxable) income of the median household owning fund shares was $55,000.[33] Because of deductions and personal exemptions, the median fund shareholder's taxable income was far less. Indeed, the marginal tax rate for 1999 for the median fund shareholder filing a joint tax return—whether or not the shareholder had children or itemized deductions—was only 15 percent for ordinary income and only 10 percent for long-term capital gains.[34]

Moreover, even if some average of the varying state and local taxes of all 50 states and the District of Columbia[35] were factored in (a path that the Commission has wisely chosen not to take),[36] the total tax burden of the "average" fund shareholder would be less than 28 percent. Thus, even our proposal overstates, perhaps to a fairly significant degree, the actual combined federal, state and local tax rate applicable to the average fund shareholder.

By contrast, the Commission's proposal to use the highest marginal federal tax rates would result in most investors receiving tax information that would not be applicable or meaningful to them. In 1999, for example, the 39.6 percent tax rate applied only to individuals receiving taxable income of more than $283,150; it appears that less than 1 percent of both taxpayers generally[37] and fund shareholders are taxed at this rate.[38]

Use of the highest tax rate would be particularly inappropriate for those funds (such as bond funds) that invest in income-producing instruments. Top tax-bracket investors who seek current income typically invest in tax-exempt, rather than taxable, bond funds. The proposal's use of the highest tax rate would significantly overstate the tax consequences of those more moderate-income investors

who invest in taxable funds.[39]

The use of higher (and therefore less representative) tax rates also would have the effect of inappropriately skewing investment decisions, particularly at the margin. The use of a 39.6 percent tax rate, for example, could overstate significantly the tax impact of ordinary income distributions. This overstatement of tax impact could cause funds that distribute less of their total return as ordinary income to appear to be far more attractive to lower-bracket investors (on a relative after-tax basis) than they really are. [40]

The reasons given in the Proposing Release for using the highest tax rates to calculate after-tax returns are not sufficient to overcome these objections. For example, we disagree with the suggestion that the mandatory use of the highest tax rate is supported by "current industry practice." While it is true that a few firms voluntarily calculate after-tax returns and that the highest tax rates "frequently" are used, the practice of reporting after-tax returns is so new that no "industry practice" exists. Moreover, the voluntary disclosure that exists today is directed largely at those taxpayers most interested in the tax consequences of fund investing—who are (not surprisingly) in the highest rate brackets. Any mandatory disclosure designed for fund investors generally should take into account the fact that all fund investors will receive it.

We also disagree with the Proposing Release's statement that a "worst-case" maximum tax rate scenario should be provided because, when "[c]oupled with before-tax returns that reflect the imposition of taxes at a 0 percent rate, this 'worst-case' scenario will effectively provide investors with the full range of historical after-tax returns."[41] Only two methods exist for showing the "full range" of after-tax returns. First, funds could disclose the after-tax returns for each marginal tax rate (beginning with 15 percent, rather than zero). This requirement would result in such cumbersome disclosure, however, that the Commission correctly has not even asked for comment on it. Second, funds could disclose the portion of the total return attributable to amounts (1) not currently taxed, (2) taxed as ordinary income and (3) taxed as long-term capital gains.[42] Although this approach for providing information on the "full range" of tax consequences of investing appears quite straightforward, the Commission likewise has not requested comment on it.

The Proposing Release also suggests that using an "intermediate" rate would be too complex. The chart that appears in footnote 31 of this letter—which shows the rates that would be applied under the Institute's proposal for the past ten full calendar years and currently—is no more complex than the top marginal rate chart on page 29 of the Proposing Release. Use of a "middle" tax rate also has the benefit of consistency. While the top marginal rate for ordinary income received over the past ten years has ranged from 31 percent to 39.6 percent, the marginal tax rate applicable to the "average" fund investor with $55,000 of taxable income has been 28 percent for the entire ten-year period.

One remaining question is whether the $55,000 taxable income amount should be adjusted for inflation. We believe it should not be. Instead, the Commission should retain the discretion to make adjustments to this $55,000 amount, on a prospective-only basis, pursuant to its general rulemaking authority, for the following reasons.[43] First, such changes presumably would not be frequent. So long as the current tax rate schedule remains in effect, there should be no need in the foreseeable future to adjust the $55,000 amount. This is because, while the brackets are indexed for inflation, the lower end of the 28 percent bracket is currently only $43,050, and thus is unlikely to be inflation-adjusted to more than $55,000 for several more years. Accordingly, adjusting the $55,000 amount for inflation would not be necessary to keep the current rates in effect. Second, any modification should reflect changes in the median household income amount, which would not necessarily be the same as an inflation adjustment. For example, if significantly more lower-income Americans were to purchase mutual fund shares, it might be appropriate to lower the $55,000 amount, even if an inflation adjustment would have resulted in an increase.

While it is true that this approach would place some responsibility upon the Commission to consider adjustments from time to time, any resulting burdens would be minimal in that they likely would be very infrequent and relatively straightforward. Especially in light of this fact, we do not believe that it would be appropriate to let the desire to avoid future rulemaking outweigh the need for the rule to utilize the fairest and most meaningful tax rate.

B. Holding Periods

The Commission has proposed to require that redemption gains or losses be treated as either short-term or long-term based upon the actual period that the hypothetical fund shares were held. We disagree with this approach, as it would unnecessarily complicate the calculation of a hypothetical redemption. Instead, all hypothetically-redeemed shares (including shares purchased with reinvested dividends) should be treated as generating long-term capital gains or losses.[44] This approach is supported by, among other things, the holding period experience of the average fund shareholder, who typically holds fund shares for several years.

It would be particularly inappropriate to impose an ordinary income tax rate to the one-year "post-liquidation" after-tax return (the gain or loss on which is treated as "short-term") when the applicable rate the very next day would drop to 20 percent (because shares held for one year and one day get long-term capital gain treatment). This treatment (particularly if the Commission's proposed 39.6 percent tax rate were used) could overstate quite significantly the tax consequences of investing for approximately (as opposed to exactly) one year. Given that few if any investors ever redeem one day before any tax on a gain would be cut in half, we believe it is

quite unrealistic to treat one-year redemption gains as short-term.

We further believe that little if any benefit would be derived from treating any gain or loss on shares acquired by dividend reinvestment during the current calendar year as short-term. First, the number of new shares acquired by dividend reinvestment typically would be small relative to the number of shares already held for the long-term holding period. Second, any gain or loss on the shares acquired by reinvestment would be attributable only to changes in value between the reinvestment date—typically late in the calendar year for distributions of capital gains (both long-term and short-term) and dividend income—and the end of the calendar year. Thus, any gain or loss on shares acquired by reinvestment in the current calendar year most likely would be small.

C. Other Aspects of the Proposed Formula

1. Other Federal Taxes

The Commission's proposal would not adjust after-tax returns to reflect the impact of either the alternative minimum tax or the phase-outs of itemized deductions and personal exemptions. We agree with this exclusion. As the Proposing Release indicates, "adjusting after-tax returns to reflect the impact of these provisions of tax law would complicate the after-tax return calculations without providing a commensurate benefit to a significant number of investors."[45]

2. State and Local Taxes

The Commission's proposal would not adjust after-tax returns to reflect the impact of state and local taxes. We agree with this exclusion. The Proposing Release correctly recognizes that because state and local taxes vary widely, no single tax rate could adequately serve as a reasonable proxy for the state and local tax burden.[46] Moreover, presenting separate after-tax returns for all fifty states and the District of Columbia would be overwhelming for investors and burdensome for funds. However, it is important that funds calculating after-tax returns using any mandated formula be permitted also to calculate and disclose after-tax return, if they wish, by including the impact, if any, of state and local taxes.[47]

3. Historic Tax Rate

The Institute supports the proposal to use the historic tax rates in effect during the 1-, 5- and 10-year periods to compute after-tax returns for these periods. As the Commission correctly notes in the Proposing Release, several strong policy arguments support the use of historic tax rates.[48] First, historic rates more accurately reflect the actual after-tax return experience of a shareholder in the fund for the measurement period. In contrast, applying current rates may overstate or understate the tax impact of distributions made in prior years. Second, it would be particularly unfair to apply current tax rates to the return of any fund that sought to maximize after-tax returns, since the portfolio management decisions made by the fund would have reflected the tax rates in effect at that time. Finally, the use of historic rates simplifies the ongoing calculation of after-tax return; were current tax rates used, after-tax returns for every period would need to be recalculated each time the applicable federal tax rate was changed for any year.

4. Timing and Method of Payment

The Institute supports the Commission's proposal to treat any taxes due on distributions as paid at the time of the distribution[49] by reinvesting only the net (after-tax) amount. The method proposed by the Commission would simplify the calculation of after-tax returns by not requiring the funds to assume that a redemption is made later (such as on December 31 or the following April 15) to generate cash to pay the tax attributable to the distribution. Among other things, this subsequent redemption would create its own tax liability. Moreover, because many investors either adjust their wage withholding (or make estimated tax payments) to ensure adequate tax withholding for the taxable year, it is quite reasonable to assume that taxes are paid as the income giving rise to the tax liability is received.

5. Tax Treatment of Distributions

The Institute supports the proposal to treat the taxable amount and tax character of each distribution as specified by the fund on the dividend declaration date, adjusted to reflect subsequent recharacterizations. [50] Thus, nontaxable distributions should have no impact on a fund's after-tax returns and the treatment of any distributed amount that is taxed other than as regular ordinary income also should be reflected in the calculation. For example, each special subcategory of long-term capital gains, such as qualified 5-year gains, should be reflected as such in the calculation.

Similarly, a fund distributing amounts on which an investor may claim the foreign tax credit should be given the option of taking the availability of the foreign tax credit into account, on a calendar year basis, in calculating after-tax return. As this credit can be quite beneficial to investors, it should be reflected in the formula as it is on an investor's tax return: by grossing up the distributable amount by the amount of the foreign tax, treating the full amount as a credit against U.S. tax liability,[51] and reducing or increasing the cash dividend to reflect the difference between the U.S. tax liability and the amount of the foreign tax credit.[52]

6. Capital Losses

The Institute supports the Commission's proposal to permit funds to calculate post-liquidation after-tax returns by treating any redemption loss (all of which would be long-term under our proposal) as offsetting a corresponding amount of capital gain of the same type (i.e., long-term) from unrelated transactions. Under the tax rules, capital losses incurred by individuals first offset unrelated capital gains and then reduce ordinary income (up to $3,000 each year). The Commission's proposal—which disregards this "extra" benefit of offsetting some amount of ordinary income with capital losses—is (a) conservative (i.e., it offsets first income taxed at more preferential (i.e., 20 percent) rates), (b) simple (i.e., it does not require assumptions about the amount by which an investor's loss exceeds the investor's unrelated gains) and (c) appropriate (e.g., it helps to ensure that all tax attributes of fund investing are given equal effect).

VI. Exemptions From The Disclosure Requirement

A. Proposed Exemptions

The Commission has proposed two broad exemptions from the disclosure requirement, both of which the Institute supports.[53] First, the Commission's proposal would permit a fund to omit the after-tax return information in a prospectus used exclusively to offer fund shares as investment options for: (1) a defined contribution plan that meets the requirements for qualification under Section 401(k) of the Internal Revenue Code; (2) a tax-deferred arrangement under Section 403(b) or 457 of the Code; (3) a variable insurance contract as defined in Section 817(d) of the Code, if covered in a separate account prospectus; or (4) a similar plan or arrangement pursuant to which an investor is not taxed on his or her investment in the fund until the investment is sold.[54] This exemption is appropriate because such plans and arrangements do not have current tax consequences for their shareholders. We also note that this exemption is equally appropriate for the prospectuses of those funds that are offered to tax-exempt investors (e.g., foundations, colleges and universities) and investors who are not subject to individual income tax rates (e.g., corporations). After-tax return calculations that would be provided pursuant to the rule would be irrelevant to these investors. Accordingly, we recommend that the proposed exemption be revised to include tax-exempt investors and to clarify that it covers all tax-deferred plans and arrangements.[55]

Second, the Commission's proposal would exempt money market funds from the requirement to disclose after-tax returns. The Institute also strongly supports this exemption. Since all of the income arising from a money market fund generally is taxable currently as ordinary income, there should be no difference between the relative performance of these funds on a before-tax basis and their relative performance on an after-tax basis. Put another way, if Fund A has a better before-tax return than Fund B, it also will have a better after-tax return.[56] Thus, after-tax return information would be, at best, of only marginal benefit to investors.

B. Additional Exemption for Bond Funds

In addition to the exemptions under the proposal, we recommend that the Commission also exempt bond funds from the disclosure requirement.[57] 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. As noted in the Proposing Release, and as understood by tax-exempt bond fund investors, periodic distributions by a tax-exempt bond fund generally will be completely exempt from tax.[58] Taxable bond fund investors likewise know that their periodic distributions are subject to current tax. After-tax return disclosure is not necessary for these investors to appreciate the tax consequences of receiving such periodic distributions.

Indeed, because of the importance that bond fund investors place on current income, the Commission many years ago standardized the calculations of yield and tax-equivalent yield. These yield formulas already provide investors with measurement tools for comparing (1) tax-exempt bond funds with each other, (2) taxable bond funds with each other, and (3) tax-exempt bond funds with taxable bond funds.[59] Thus, it is doubtful that requiring bond funds to disclose their after-tax returns would provide benefits sufficient to outweigh the associated burdens and complexities.

If, however, the Commission is unwilling to exclude bond funds in the manner that we have proposed, we strongly recommend that, at the very least, the Commission exclude tax-exempt bond funds[60] from after-tax return disclosure. Such an exemption is appropriate because, as noted above, the tax consequence of distributions made by tax-exempt bond funds to their shareholders is minimal.

VII. Compliance Date

The Commission proposes 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 Commission requested comment on the proposed compliance date.

The compliance date proposed by the Commission would be inadequate in most circumstances. Compliance with the proposed

amendments will require extensive systems and prospectus changes. Moreover, these changes cannot be initiated in advance of the proposals' final adoption and will require careful attention, detailed testing and multi-level review.

For these reasons, we urge the Commission to increase the proposed transition period to 12 months after the effective date of the amendments. This period would give funds sufficient time to modify their systems and revise their disclosure documents in accordance with the new requirements. We believe, however, that it would be appropriate to require funds that include after-tax returns in advertisements and sales literature to include standardized numbers in accordance with the Commission's proposed six-month transition period.

We further recommend 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. Allowing funds to do so would be appropriate given that the after-tax return numbers included in such a filing will be calculated pursuant to a standardized formula and the accompanying narrative will cover specific items prescribed by the Commission in Form N-1A.

VIII. Need For The Commission ToRe-Evaluate Rules If Tax Law Is Changed

The Commission's proposal, as well as the pending legislation that would direct the SEC to adopt rules in this area, both are premised upon the current tax regime applicable to mutual fund shareholders. If Congress significantly changes this regime in the future, it will be incumbent upon the SEC to reconsider whatever disclosure rules it ultimately adopts. This is not a theoretical matter; such proposals are currently under active consideration. For example, a bill was introduced last year that would permit taxpayers to deduct each year from taxable income up to $5,000 in capital gains. [61] If legislation excluding these gains from tax were to be enacted, it is possible that a significant portion of fund shareholders would no longer incur tax liability as a result of capital gain distributions from their funds or, at the very least, their tax liability would be significantly reduced. Proposals also have been made to permit fund shareholders to defer tax on reinvested capital gain distributions,[62] in which case they would incur no (or significantly less) current tax liability from fund capital gains distributions. Under either approach (and possibly others as well), the after-tax return numbers contemplated under the proposal would be of little relevance. Accordingly, the SEC should state in its adopting release that the after-tax disclosure that would be required is based upon the current tax regime and that it will re-evaluate the disclosure if that regime is changed in any significant manner.

* * *

The Institute appreciates the opportunity to present its views on the Commission's proposals. If you have any questions or would like additional information, please contact the undersigned at (202) 326-5815, Amy Lancellotta at (202) 326-5824, or Keith Lawson at

(202) 326-5832.

Sincerely,

Craig S. Tyle
General Counsel

Attachments

cc: Paul F. Roye, Director
Susan Nash, Senior Assistant Director
Kimberly Dopkin Rasevic, Assistant Director
Maura S. McNulty, Senior Counsel
Division of Investment Management

Appendix

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,051 open-end investment companies ("mutual funds"), 497 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.009 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

[2] SEC Release Nos. 33-7809; 34-42528; IC-24339, dated March 15, 2000 (the "Proposing Release").

[3] The Institute testified in support of this concept at a congressional hearing on a bill introduced to require the Commission to revise its regulations to require improved disclosure of mutual fund after-tax returns. The Mutual Fund Tax Awareness Act of 1999: Hearings on H.R. 1089 Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce, 106th Cong., 1st Sess. (1999) (statement of Matthew P. Fink, President, Investment Company Institute).

[4] SEC Release Nos. 33-7512; 34-39748; IC-23064, dated March 13, 1998.

[5] SEC Release Nos. 33-6383; 34-18524; IC-12264, dated March 3, 1982 (emphasis added).

[6] The Mutual Fund Tax Awareness Act of 2000, H.R. 1089, 106th Cong., 2nd Sess. (2000)(emphasis added).

[7] The Mutual Fund Tax Awareness Act of 1999, H.R. 1089, 106th Cong., 1st Sess. (1999).

[8] Proposing Release at 11.

[9] See Internal Revenue Code Section 4982.

[10] In addition, certain tax consequences of fund investing (such as the use of foreign tax credits) effectively are determined on a calendar year basis through tax reporting on IRS Forms 1099.

[11] Disclosure regarding the tax consequences of investing in a fund is required under Item 7(e) of Form N-1A.

[12] Proposing Release at 18.

[13] As noted below in Section III, we disagree with the Commission's proposals to require a new set of before-tax numbers and to require all classes of a fund to disclose their after-tax returns.

[14] The only narrative disclosure generally required for before-tax returns is a statement to the effect that past performance is not necessarily an indication of how the fund will perform in the future. (Additional disclosure is required in connection with the bar chart if a fund's shares are subject to a sales load or account fee. Item 2(c)(2) of Form N-1A.)

[15] In most instances, the same prospectus is used for a fund that is offered as an investment in both taxable and tax-deferred accounts.

[16] As of December 31, 1999, the percentage of long-term mutual fund assets held in tax-qualified accounts approximated 42 percent. ICI Fundamentals, Vol. 9, No. 2, dated May 2000. An additional 11 percent of long-term mutual fund assets were held in variable annuities outside of tax-qualified plans.

[17] While under our proposal the sets of numbers that funds would be required to include in after-tax returns presentations would be reduced from four to two sets of numbers, the presentation should still be in a standardized tabular format, as proposed. This format would make it easier for investors both to compare funds and to understand the differences between the two sets of numbers.

[18] As discussed below, the Institute supports the SEC's proposal to require two sets of after-tax numbers, which would show the impact of taxes realized from fund distributions alone and from distributions and redemptions.

[19] Proposing Release at 14.

[20] Id. at 14-15.

[21] The same distortion would exist in the case of the "pre-liquidation" after-tax performance numbers.

[22] It also would avoid requiring funds to recalculate, on a retroactive basis, before-tax return numbers that were previously reported in periods prior to the adoption of these amendments.

[23] The primary differences between classes in a multiple class fund are the differences in expenses. While it is the case that the effect of different expenses may result in different dividend distributions and net asset values for each class, the benefit of showing returns for all classes in order to reflect these differences would not outweigh the negative consequences of requiring such extensive disclosure.

[24] Instruction 3(a) to Item 2(c)(2) of Form N-1A.

[25] If the Commission is not inclined to limit the disclosure for multiple class funds as recommended above, we request clarification that after-tax returns disclosure would not be required for a class that is offered only for investment through tax-deferred accounts or

to tax-exempt or corporate shareholders. This clarification is consistent with the proposed exemption for a prospectus of a fund that is offered as an investment option for certain tax-deferred plans or arrangements.

[26] Proposing Release at 15.

[27] Proposed Items 2(c)(2)(iv)(B) and 5(b)(3)(ii) of Form N-1A.

[28] Proposed Items 2(c)(2)(iv)(C)(2) and 5(b)(3)(iii)(B) of Form N-1A.

[29] We propose using married filing jointly status because over two-thirds of fund shareholders are married. See ICI Mutual Fund Fact Book (40th ed.) at 46. In fact, there was no difference in marginal federal income tax rates during 1999 for taxpayers with $55,000 of taxable income whose tax filing status was single, married filing jointly or a head of household.

[30] The 28 percent tax bracket applied during 1999 to married persons filing jointly with taxable income of between $43,050 and $104,050.

[31] Under the Institute's proposal, the rates to be used for computing after-tax returns on amounts taxed as ordinary income and as long-term capital gains for the most recent ten complete calendar years and the current calendar year would be as follows:

Year	Long-Term Capital Gains	Mid-Term Gains	Short-Term Gains/Ordinary Income
2000	20%		28%
1999	20%		28%
1998	20%		28%
7/29-12/31 1997	20%	28%	28%
5/7-7/28 1997	20%		28%
1/1-5/6 1997	28%		28%
1996	28%		28%
1995	28%		28%
1994	28%		28%
1993	28%		28%
1992	28%		28%
1991	28%		28%
1990	28%		28%

[32] http://www.irs.gov/pub/irs-pdf/i1040tt.pdf

[33] See ICI Fact Book, supra note 29, at 44.

[34] An investor with adjusted gross income of $55,000 filing a joint return that claims two exemptions (at $2,750 each) and the standard deduction (at $7,200) would have taxable income of $42,300, none of which would be taxed at any rate higher than 15 percent.

[35] State income tax rates range from a low of zero to a high of 12 percent (although taxpayers in the "12 percent" state, and several other "high-tax-bracket" states, may deduct their federal tax payments in computing their taxable income for state tax purposes). Source: Federation of Tax Administrators, February 2000, http://www.taxadmin.org/fta/rate/ind_inc.pdf.

[36] See Subsection C.2. (State and Local Taxes), below.

[37] Source: Statistics of Income Bulletin, Fall 1999 Issue, Individual Income Tax Returns, 1997, by David Campbell and Michael Parisi, p. 33.

[38] Source: Unpublished data for 1997 collected in 1998 for ICI's 1998 Profile of Mutual Fund Shareholders.

[39] As discussed below, the Institute recommends that the Commission exempt bond funds from the proposal.

[40] For example, assume a bond fund with total return of 5 percent, all of which is attributable to interest income that is distributed during the calendar year. If a 39.6 percent tax rate is applied to this 5 percent pre-tax return, the after-distribution, after-tax return is 3.02 percent. In contrast, the after-distribution, after-tax return increases to 3.6 percent if a 28 percent rate is applied and to 4.25 percent if a 15 percent rate is applied. Clearly, for an investor in the 15 or 28 percent rate brackets, using a 39.6 percent tax rate to calculate after-tax returns significantly overstates the tax impact of the fund's distributions and could inappropriately dissuade the investor from investing in the fund.

[41] Proposing Release at 26.

[42] Under such an approach, a fund might disclose, for example, that 60 percent of the reported total return was unrealized gain, 30 percent was distributable net long-term capital gain and 10 percent was distributable ordinary income.

[43] This approach was taken when Form N-1A was amended. There, the Commission revised the required fee table example by increasing the amount of the hypothetical initial investment used in the example from $1,000 to $10,000.

[44] Beginning in 2006, gains on fund shares acquired after December 31, 2000 and held for more than 5 years should be treated, for purposes of the after-tax return calculation, as it is for federal tax purposes – as qualified 5-year gain that is taxed at a maximum rate of 18 percent.

[45] Proposing Release at 32.

[46] These variances include significant differences in tax rates, in holding periods for lower capital gains tax rates, in definitions of taxable and tax-exempt income (which may vary significantly from the federal tax definitions), and in the treatment of federal taxes (which often are deductible in states with higher tax rates).

[47] We understand that, by excluding state and local taxes from this proposal, the Commission is not in any way suggesting that municipal bond funds would no longer be permitted to take into account the impact that state and local taxes have on their taxable-equivalent yields (as determined in accordance with existing SEC guidance).

[48] Proposing Release at 28.

[49] Any distribution received by a shareholder in January that is treated for federal tax purposes as received on the preceding December 31 (pursuant to Section 852(b)(7) of the Internal Revenue Code) likewise should be treated for purposes of after-tax return calculations as received by the shareholder on December 31.

[50] The determining characterization for the calendar year calculations proposed by the Institute would be the information provided on IRS Forms 1099-DIV, on which the fund reports the annual tax consequences of investing to its shareholders. To the extent that the fund revised this tax information on amended Forms 1099-DIV, such revisions would be subsequent recharacterizations for purposes of after-tax calculations. Any such recharacterization should not require a fund to sticker its prospectus or existing advertising or sales literature; instead, the revised after-tax numbers should be used in all subsequently printed materials. We request clarification on this point.

[51] For purposes of this calculation, it is assumed that no limitation would apply to a shareholder's ability to use the credit.

[52] For example, assume a dividend distribution of $100 on which foreign taxes of $15 were paid; further assume that the fund elects to flow through to the fund shareholder the opportunity to claim the foreign tax credit. The shareholder's dividend for U.S. tax purposes is grossed up to $115, on which $32.20 of US tax would be due (at a 28 percent rate). This $32.20 tax liability would be satisfied by the $15 credit and a $17.20 reduction in the amount of the reinvested cash dividend. Thus, the amount of the "after-tax" reinvested dividend would be $82.80 ($115 minus $32.20 or $100 minus $17.20).

[53] In addition, the Commission should exempt any fund that becomes a regulated investment company that qualifies for taxation under Subchapter M of the Internal Revenue Code ("RIC") after having been taxed as something else for its pre-RIC years (e.g., a bank common trust fund that converted to RIC status). Such a fund could not comply with the proposed rules with respect to its pre-RIC years because of differing tax treatment for those years (e.g., the absence of any requirement to distribute income to investors by December 31), and therefore should be exempt from the proposal for those years.

[54] We are concerned that footnote 51 in the Proposing Release may inadvertently narrow the scope of the catch-all provision in subsection (4) of the exemption in that it states that this provision applies to new types of plans adopted in the future, and is silent on

existing plans and arrangements not otherwise enumerated. Consequently, the proposed exemption could be interpreted to apply to a smaller universe than we believe was intended by the Commission. (For example, Individual Retirement Accounts and Simplified Employee Pensions would not be included.) The Commission should clarify the intended scope of the exemption in its release adopting the proposal to avoid any confusion as a result of footnote 51.

[55] As a technical matter, we recommend that instead of enumerating specific exemptions and providing a catch-all exemption, the language of the exemption be simplified to cover all tax-qualified retirement plans and other tax-deferred plans and arrangements and tax-exempt investors. This change would address another technical problem with the exemption as drafted. Frequently, variable insurance contracts are issued to investors in private offerings, which would not be "covered in a separate account prospectus." These contracts should be covered by the exemption, although as drafted they would not be.

[56] In addition, money market funds could be competitively disadvantaged were they subjected to after-tax return disclosure. Specifically, requiring these funds to disclose after-tax return could place them at a competitive disadvantage when compared to competing financial products that are not subject to an after-tax return disclosure requirement.

[57] For these purposes, a bond fund could be defined as a fund that could be called a "bond fund" under the informal standard used by the Commission staff (i.e., a fund that has at least 65 percent of its assets invested in fixed-income securities).

[58] See Proposing Release at 22-23. Tax-exempt bond funds generally receive taxable income in only two ways. First, these funds may realize capital gains (long-term or short-term) from the disposition of portfolio securities. Second, these funds may realize taxable ordinary income in the form of market discount. Shareholders in tax-exempt bond funds also may realize a taxable gain or loss when they redeem their fund shares.

[59] We request clarification that disclosure of tax-equivalent yields in advertising or sales literature would not trigger the requirement to disclose after-tax returns under the proposal.

[60] For this purpose, a "tax-exempt bond fund" could be defined, in accordance with informal Commission staff positions, as (1) a fund that invests its assets so that at least 80 percent of the income will be tax-exempt or (2) a fund that has at least 80 percent of its net assets invested in tax-exempt securities.

[61] See S. 593 (introduced last year by Senators Coverdell, Torricelli and Abraham).

[62] See, e.g., H.R. 4723 (introduced on June 22, 2000 by Rep. Jim Saxton, Vice Chairman of the Joint Economic Committee).
