

Comment Letter on Inflation-Protection Securities, July 1996

July 3, 1996

The Honorable Robert E. Rubin
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 3330
Washington, D.C. 20220

Re: Inflation-Protection Securities

Dear Secretary Rubin:

The Investment Company Institute¹ appreciates the opportunity to comment on the Department of the Treasury's proposal to issue debt obligations providing protection from inflation.² These so-called "inflation-protection" securities could provide important benefits for our economy and represent an attractive opportunity for investors. We support the Treasury Department's initiative in introducing a new security that would offer explicit inflation protection to investors, a feature never before available in a U.S. Treasury instrument.

The investment company industry agrees that inflation-protection securities could advance two important objectives — saving on interest costs to the United States government and broadening the types of debt instruments available to investors in the financial markets.

If structured correctly, these securities should prove to be attractive both to individual and institutional investors and in the pension and retirement markets.

Our comments concern how the Treasury Department might best ensure that inflation-protection securities gain wide acceptance with the American investing public, and hence the broadest possible market. Specifically, we recommend that:

- (1) the securities be offered in a broad range of maturities, including short-term, intermediate-term and long-term;
- (2) the securities be designed to meet, or be capable of being purchased by investment companies to meet, investor expectations;
- (3) certain operational issues relevant to investment companies be clarified; and
- (4) the structure of the securities be reconsidered periodically, especially during the first few years of issuance, to ensure that the securities meet the needs of the Treasury Department and the investing public.

We believe that these measures, as discussed in more detail below, would make inflation-protection securities more attractive to investment companies and to the investing public at large.

I. Background

A. Benefits of Inflation-Protection Securities

Inflation-protection securities could provide the United States with several important benefits. First, because investors would be willing to accept a lower coupon rate on debt obligations providing protection from inflation, the cost of servicing the Federal debt could be reduced. Any reduction in the Federal Government's borrowing costs could free up additional capital for investment in U.S. businesses, thereby helping to increase the return on savings and improve our standard of living.

Second, inflation-protection securities would provide the Federal Government with a significant incentive to pursue fiscal and

monetary policies that would keep the inflation rate low and stable. As capital markets are more efficient when inflation is kept to relatively low and stable levels, the issuance of inflation-protection securities could help increase investment returns for all investors.

Third, inflation-protection securities would provide comfort to those Americans most concerned about the negative impact that inflation could have on their financial security. Increased investor confidence could provide important benefits for our economy.

B. Investment Company Participation in the U.S. Government Securities Market

The three principal types of investment companies — mutual funds, closed-end funds and unit investment trusts³ — are significant participants in the U.S. Government securities market. For example, of the \$3.0 trillion invested in U.S. mutual funds at the end of the first quarter of 1996, approximately \$197 billion was invested in marketable Treasury bills, notes and bonds, and approximately \$250 billion was invested in other U.S. Government obligations.⁴ Today, there are approximately 333 "U.S. Government bond funds" with assets of \$84.7 billion that invest primarily in U.S. Government securities with maturities exceeding one year and 389 "U.S. Government-only money market funds" with assets of \$206.3 billion that generally invest only in U.S. Government securities with remaining maturities of 397 days or less.

There are several reasons why U.S. Government bond and money market funds, like all investment companies, are such popular investment vehicles. First, these funds provide investors of moderate means with professional management and diversification of risk comparable to that achieved by wealthy investors who purchase securities directly. A second important feature of these funds is the liquidity that results from the ease with which their shares may be purchased and sold. Mutual fund shares, for example, typically are subject to a continuous public offering and may be redeemed upon shareholder demand for a price equal to the fund's net asset value. Third, the funds provide investors with the opportunity to make additional purchases of shares in small increments, including through dividend reinvestment programs.⁵ A fourth reason for the popularity of U.S. Government bond and money market funds is the wide array of distribution channels (e.g., full service brokers, discount brokers, banks, financial planners and direct marketers) through which their shares are marketed. Investors have many options when it comes to seeking advice regarding which funds to invest in.

Depending upon how inflation-protection securities are structured, mutual funds and other investment companies might become active participants in this new market, either by organizing new investment companies to invest primarily in these securities or by buying these new obligations for portfolios of existing investment companies, such as U.S. Government bond funds.

II. Recommendations

A. Issuing Securities with a Broad Range of Maturities

The Treasury Department presently contemplates issuing inflation-protection securities with maturities of 10 and 30 years. It is proposed that the securities be auctioned on a regular quarterly schedule, with competitive and noncompetitive bidding.

To expand the market for inflation protection securities, the Institute recommends that the Treasury Department issue inflation-protection securities with a broader range of maturities, including short-term (1 to 5 years), intermediate-term (5 to 10 years) and long-term (more than 10 years). We believe that by offering a broader range of maturities, the Treasury Department will greatly increase the investment demand in these securities by both individual and institutional investors.⁶

Today's market for U.S. Government securities reflects investor preferences for securities with varying maturities. This preference is reflected in the large number of bond funds that provide investors with a portfolio of fixed income securities that meet specific maturity limitations. A large proportion of mutual fund fixed income assets are invested in securities with maturities of less than ten years.

If investors cannot purchase inflation-protection securities with maturities spread more evenly across the yield curve, the Institute believes that the overall market appeal of these securities may be limited, particularly in the early years of their issuance. By issuing a broader range of maturities, the Treasury Department would provide investors with more options in developing investment strategies that meet their long-term or short-term investment goals and risk/return profile. For example, an investor who desires a conservative investment strategy with below-average volatility might wish to purchase only inflation-protection securities with short-term or intermediate-term maturities.

In order to provide investors with the particular risk/return features that they desire, without broader maturities, it may be necessary for investment companies to delay purchasing inflation-protection securities until the Treasury Department had been issuing these securities for several years and a sufficiently large secondary market of securities with varying remaining maturities had developed. For example, if the Treasury Department issued only 10- and 30-year obligations, mutual funds would have a very difficult time, particularly in the early years of the program, creating portfolios for groups of investors who have similar investment objectives and risk tolerances.⁷

It appears unlikely that the broad range of maturities needed for significant investor interest can be generated, at least in the first several years of the program, from an initiative that shortens the maturity of inflation-protection securities by separating the principal and interest components for sale separately ("inflation-protection strips"). As we understand the Treasury Department's current plans, it may take six months or a year before the securities will be strippable on the Federal Reserve's Book Entry System and then, given the relatively low coupons on the securities, it may take several more years before the volume of stripped instruments is sufficiently large to package these instruments for purchase by investment companies. Thus, we submit, the only way to create a broad range of maturities in the near term would be for the Treasury Department to issue short-term, intermediate-term and long-term securities.

B. Meeting Investor Expectations

For inflation-protection securities to have broad market appeal, it will be imperative that the consequences of holding these securities be consistent with investor expectations. Without at this time expressing an opinion on a "preferred" structure for these securities, we would note that inflation-protection securities that do not pay out the inflation adjustment to principal on a current basis may be more volatile than those that pay out this adjustment currently. On the other hand, an inflation-protection security that does not pay inflation adjustments to principal currently may be more "strippable," which could become more important as the volume of these obligations increases. The most appropriate structure will depend on many factors, including whether the Treasury Department adopts the Institute's recommendation to issue inflation-protection securities in a broader range of maturities.

1. Volatility

The Treasury Department's proposal on inflation-protection securities indicates that the structure currently receiving primary consideration would be modeled, with some modifications, on the Real Return Bonds currently issued by the Canadian Government. Under this structure, the security's principal amount would be adjusted for inflation; semiannual interest payments would be made equal to a fixed percentage of the value in current dollars of the principal amount, adjusted semiannually for inflation; and the adjusted principal amount would be paid at maturity.

Under the Canadian structure, the par value of the inflation-protection securities would increase over time. The longer the instrument's maturity, the more volatile the current market value of the inflation-protection security would become relative to a comparable obligation that paid the principal inflation adjustment currently.

Individual investors, in particular, might expect U.S. Government securities with an inflation adjustment — a particularly safe investment — to be more stable in value. These investors might become dissatisfied with inflation-protection securities if they exhibited more volatility than expected.

Volatility concerns may to some extent be minimized if investors purchase inflation-protection securities through investment companies. First, to the extent that a sufficiently broad range of maturities exists, investment companies can manage their portfolios to reduce volatility. Second, investors purchasing these obligations through investment companies registered under the Investment Company Act of 1940 would receive prospectus disclosure, educating investors on volatility issues.

2. Cash Flow Issues

Under the proposed Canadian structure for inflation-protection securities, both the interest income and the principal adjustment would be income taxable on a current basis, even though the inflation adjustments to principal would not be paid out currently. Individual investors, particularly those relatively unsophisticated investors drawn to a "safe" inflation-protected U.S. Government security, might be surprised that the Canadian model generated current taxable income without an equivalent current cash payment — a situation often described as "phantom income." Investors seeking current income, such as retirees living on investment income, also might prefer investments that generated greater cash flow than would be paid by the Canadian model.

Should the Treasury Department adopt the Canadian structure, investment companies could provide investors seeking current cash payments equal to taxable income with the option of receiving these payments currently. Investment companies could provide this benefit because they effectively are required by the Internal Revenue Code to provide cash dividends to all investors other than those electing not to participate in a dividend reinvestment program. In the mutual fund context, the fund may be able to generate sufficient cash (e.g., through new share purchases) to pay dividends without selling securities. For unit investment trusts, which usually sell a fixed number of units to investors and often do not provide investors with the option of reinvesting dividends, it is more likely that portfolio securities would be needed to be sold to generate cash.

C. Operational Issues for Investment Companies

We understand that the Treasury Department intends for the appropriate inflation adjustment for each income accrual period to be known on or before the first day of that period. For the reasons discussed below, it is critical that investment companies know each day the appropriate income accruals that are attributable to these securities.

First, an investment company cannot meet the stringent requirements imposed by the Internal Revenue Code and the Investment Company Act with respect to daily income accruals and the daily valuation of portfolio securities unless certainty exists regarding the interest income generated each day by inflation-protection securities. In this regard, it will be important that secondary market purchasers of inflation-protection securities have all information necessary to comply with any applicable market discount and premium rules.

Second, an investment company must know the amount of interest income on a daily basis if it is to meet the excise tax "minimum distribution" requirements imposed under Internal Revenue Code section 4982. These require an investment company to distribute during each calendar year essentially all of its (1) ordinary income earned during the calendar year and (2) capital gain net income arising during the 12-month period beginning November 1 of the prior calendar year and ending on October 31 of the current year. If income arising from the disposition during November and December of an inflation-protection security were deemed "ordinary" income subject to distribution during that calendar year, investment companies could have difficulties meeting their section 4982 minimum distribution requirements. The later in the calendar year the dispositions takes place, the more likely it is that an investment company will not have sufficient time to calculate, declare and pay the necessary dividend by December 31. So long as all interest income on inflation-protection securities is accrued on a current basis, with no disposition gain being treated as ordinary income, the difficulties attributable to section 4982 will not arise.

Third, investment companies are required by the Internal Revenue Code to properly report the character of their distribution footnotes to shareholders and collect the appropriate withholding tax. In the case of investment companies that are taxable under Subchapter M (companies known as "regulated investment companies" or "RICs"), all taxable income realized by a fund is distributed either as a "dividend," taxable as ordinary income,⁸ or as a "capital gain dividend," taxable as long-term capital gain. In the case of certain unit investment trusts not taxable as RICs, where the character of income received by the investment company is retained when distributed to investors, all income generated by inflation-protection securities would be taxable to investors either as interest income or capital gain.⁹

D. Periodically Reconsidering the Structure of Inflation-Protection Securities

The Institute recommends that, as part of the proposal, the Treasury Department develop a schedule in which to seek periodically public comment from market participants as to the issuance and structure of inflation-protection securities. The proposal involves the issuance of a new security and undoubtedly there will be unexpected issues that arise both for the investing public and for money managers. Such issues might include, among other things, increased demand for or supply of certain issuances, problems associated with the accounting or tax treatment of the securities, and issues related to investor expectations.

We recommend that, as each periodic reconsideration point is reached, the Treasury Department specifically solicit public comments on whether new issuances should be structured differently. By developing a schedule in which to reassess periodically the securities' issuance and structure, the Treasury Department will be able to assure that the securities receive the broadest possible distribution.

The Institute appreciates the opportunity to comment on this important initiative. Please do not hesitate to contact me (at 202/326-5810), Keith Lawson, Associate Counsel (at 202/326-5832) or Alex Gavis, Assistant Counsel (at 202/326-5923) if the Institute can answer any questions you may have concerning our comments or if we can provide you with any additional information.

Sincerely yours,

Paul Schott Stevens
Senior Vice President
General Counsel

cc: The Honorable Alan Greenspan
Chairman
Federal Reserve Board

The Honorable Arthur Levitt, Jr.
Chairman
Securities and Exchange Commission

The Honorable Lawrence Summers
Deputy Secretary of the Treasury
Department of the Treasury

The Honorable Darcy Bradbury
Assistant Secretary for Financial Markets

Department of the Treasury

The Honorable Roger Anderson
Deputy Assistant Secretary for Federal Finance
Department of the Treasury

Government Securities Regulation Staff
Bureau of Public Debt

ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 5,951 open-end investment companies ("mutual funds"), 449 closed-end investment companies and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about \$3.056 trillion, accounting for approximately 95% of total industry assets, and have over 38 million individual shareholders.

² This letter also is being submitted to the Bureau of Public Debt in response to the Treasury Department's Advanced Notice of Proposed Rulemaking concerning inflation-protection securities. Amendments to the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes and Bonds, 61 Fed. Reg. 25164 (May 20, 1996).

³ A "mutual fund" is an investment company that manages a pool of securities, including stocks, bonds and money market instruments, that it acquires with money invested by its shareholders. A "closed-end fund," also an investment company that holds a managed pool of securities, issues a limited number of shares that trade on a stock exchange or in the over-the-counter markets. The trading value of closed-end fund shares is determined by market supply and demand. A "unit investment trust" is an investment company that generally issues a fixed number of investor interests ("units"), which are redeemable but trade at net asset value in a secondary market, and maintains an unmanaged (fixed) portfolio of income-producing or equity securities, and has a specific date on which the trust liquidates its holdings.

⁴ In addition, money market mutual funds held approximately \$100 billion of repurchase agreements, most of which are collateralized with U.S. Government securities. Long-term bond funds and equity funds also hold repurchase agreements (for which no data is available) that are collateralized with U.S. Government securities.

⁵ This may be particularly useful to investors in the context of inflation-protection securities that are issued in \$1,000 denominations. For example, an investor that participates in a fund that invests in inflation-protection securities typically could reinvest dividends received from the fund, no matter how small the amount.

⁶ For example, the Treasury Department might offer inflation-protection securities with 5-year, 10-year and 30-year maturities.

⁷ Given the advantages of convenience that investment companies offer to investors (e.g., through dividend reinvestment programs and enhanced liquidity), it is likely that some investors would be interested in purchasing inflation-protection securities through an investment company, regardless of whether a sufficiently broad range of maturities existed to permit effective management of the portfolio.

⁸ As all interest income realized by a RIC is treated for tax purposes as a dividend when paid to investors, any portfolio interest income received by a RIC — income which otherwise would be exempt from U.S. withholding tax if paid directly to a nonresident alien investor — is subject to nonresident alien withholding tax when distributed.

⁹ As all of the interest income generated by inflation-protection securities should be eligible for treatment as portfolio interest exempt from withholding tax when paid to a nonresident alien investor, unit investment trusts not organized as RICs would have no withholding tax obligation on payments to nonresident aliens.