

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230, 239, 270, and 274

[Release Nos. 33-7809; 34-42528; IC-24339; File No. S7-09-00]

RIN: 3235-AH77

Disclosure of Mutual Fund After-Tax Returns

AGENCY: Securities and Exchange Commission

ACTION: Proposed rule

SUMMARY: The Securities and Exchange Commission is proposing rule and form amendments under the Securities Act of 1933 and the Investment Company Act of 1940 to improve disclosure to investors of the effect of taxes on the performance of open-end management investment companies ("mutual funds" or "funds"). Under the proposed amendments, mutual funds would be required to disclose after-tax returns based on standardized formulas comparable to the formula currently used to calculate before-tax average annual total returns. The proposals also would require funds that include after-tax returns in advertisements and other sales materials to include standardized after-tax returns.

DATES: Comments must be received on or before June 30, 2000.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549-0609. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-09-00; this file number should be included on the subject line if E-mail is used. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, N.W., Washington, D.C. 20549-0102. Electronically submitted comment letters will be posted on the Commission's Internet site (<http://www.sec.gov>).

FOR FURTHER INFORMATION CONTACT: Maura S. McNulty, Senior Counsel, Martha B. Peterson, Special Counsel, or Kimberly Dopkin Rasevic, Assistant Director, (202) 942-0721, Office of Disclosure Regulation, Division of Investment Management, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549-0506.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission

("Commission") is proposing for comment amendments to Form N-1A [17 CFR 239.15A and 274.11A], the registration form used by mutual funds to register under the Investment Company Act of 1940 [15 U.S.C. 80a-1 *et seq.*] ("Investment Company Act") and to offer their shares under the Securities Act of 1933 [15 U.S.C. 77a *et seq.*] ("Securities Act"). The Commission also is proposing amendments to rule 482 under the Securities Act [17 CFR 230.482] and rule 34b-1 under the Investment Company Act [17 CFR 270.34b-1].

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I. Introduction

Taxes are one of the most significant costs of investing in mutual funds through taxable accounts. In 1998, mutual funds distributed approximately \$166 billion in capital gains and \$134 billion in taxable dividends.¹ Shareholders investing in stock and bond funds paid an estimated \$34 billion in taxes in 1997 on distributions by their funds.² Recent estimates

¹ Investment Company Institute ("ICI"), MUTUAL FUND FACT BOOK 56 (1999) ("1999 MUTUAL FUND FACT BOOK") (distributions of taxable dividends included \$81.9 billion on equity, hybrid, and bond funds and \$52.1 billion on money market funds).

² Liberty Funds Distributor, *Mutual Fund "Tax Pain Index" Rises Again Despite Capital Gains Rate Cut* (visited Feb. 1, 2000) <http://www.libertyfunds.com/liberty/lf/scripts/inTheNews.jsp?BV_SessionID=@@0115467702.0949422874@@@&BV_EngineID=calglcflhbbfdmckgcfjicil.0> (estimate of the tax burden based on net capital gains realized on mutual funds other than money market funds, and net investment income on equity, bond, and income funds).

suggest that more than two and one-half percentage points of the average stock fund's total return is lost each year to taxes.³ Moreover, in the last five years, it is estimated that investors in diversified U.S. stock funds surrendered an average of 15 percent of their annual gains to taxes.⁴

Despite the tax dollars at stake, many investors lack a clear understanding of the impact of taxes on their mutual fund investments.⁵ Generally, a mutual fund shareholder is taxed when he or she receives income or capital gains distributions from the fund and when the shareholder redeems fund shares at a gain.⁶ The tax consequences of distributions are a particular source of surprise to many investors when they discover that they can owe substantial taxes on their mutual fund investments that appear to be unrelated to the performance of the fund. Even if the value of a fund has declined during the year, a shareholder can owe taxes on capital gains distributions if the portfolio manager sold some of the

³ KPMG Peat Marwick LLP, *An Educational Analysis of Tax-Managed Mutual Funds and the Taxable Investor* ("KPMG Study"), at 14.

⁴ Jonathan Clements, *Fund Distributions are a Taxing Problem; How the Tax Man Dines on Your Funds*, THE WALL STREET JOURNAL, Aug. 31, 1999, at C1.

⁵ In a recent telephone survey, 1,000 mutual fund investors were asked about their tax knowledge. Eighty-five percent of respondents claimed taxes play an important role in investment decisions, but only thirty-three percent felt that they were very knowledgeable about the tax implications of investing. Eighty-two percent were unable to identify the maximum rate for long-term capital gains. The Dreyfus Corporation, *Dreyfus' 1999 Tax Informed Investing Study* (visited Jan. 14, 2000) <<http://www.dreyfus.com/>>. In another survey, 1,555 mutual fund investors were asked a variety of questions to test their knowledge about mutual funds. Only 60 percent correctly answered a question asking them to identify factors that may influence after-tax returns. Brill's Mutual Funds Interactive, *Humberto Cruz: Take the Investor Literacy Test* (visited Jan. 31, 2000) <<http://www.fundsinteractive.com/features/crz07991.html>>.

⁶ I.R.C. 61(a)(3) and (7) (providing that an individual's gross income includes dividends and gains derived from dealings in property); I.R.C. 852(b)(3)(8) (capital gain dividend from a mutual fund treated as gain from sale or exchange of capital asset held for more than one year); I.R.C. 1001 (gain from sale or other disposition of property is excess of amount realized over adjusted basis, and loss is excess of the adjusted basis over amount realized). See IRS Publication 564, *Mutual Fund Distributions* (1999), at 2-4 (explaining tax treatment of distributions of income and capital gains by mutual funds to their shareholders).

fund's underlying portfolio securities at a gain.⁷

The tax impact of mutual funds on investors can vary significantly from fund to fund. For example, the amount and character of a fund's taxable distributions are affected by its investment strategies, including the extent of a fund's investments in securities that generate dividend and other current income, the rate of portfolio turnover and the extent to which portfolio trading results in realized gains, and the degree to which portfolio losses are used to offset realized gains. One recent study reported that the annual impact of taxes on the performance of stock funds varied from zero, for the most tax-efficient funds, to 5.6 percentage points, for the least tax-efficient.⁸ While the tax efficiency of a mutual fund is of little consequence to investors in 401(k) plans or other tax-deferred vehicles, it can be very important to an investor in a taxable account, particularly a long-term investor whose tax position may be significantly enhanced by minimizing current distributions of income and capital gains.

Recently, there have been increasing calls for improvement in the disclosure of the tax consequences of mutual fund investments. Mutual funds, as well as third party providers that furnish information to mutual fund shareholders, are responding to this growing investor demand by providing after-tax returns, calculators that investors can use to compute after-tax returns, and other tax information.⁹ In

⁷ This is attributable, in part, to the fact that a mutual fund generally must distribute substantially all of its net investment income and realized capital gains to its shareholders in order to qualify for favorable tax treatment as a "regulated investment company" ("RIC"). I.R.C. 852 and 4982(b). As a RIC, a mutual fund is generally entitled to deduct dividends paid to shareholders, resulting in its shareholders being subject to only one level of taxation on the income and gains distributed to them. I.R.C. 851 (circumstances under which an investment company may be treated as a RIC) and 852(b)(2) (calculation of taxable income of a RIC).

See, e.g., *Year-End Tax Tips*, Bob Edwards (National Public Radio, Morning Edition radio broadcast, Dec. 28, 1999) (describing tax consequences of mutual fund distributions as a "shock" to investors).

⁸ KPMG study, *supra* note 3, at 14 (reporting the impact of taxes on performance of 496 stock funds for the ten-year period ending December 31, 1997).

⁹ For example, Eaton Vance Management and The Vanguard Group have recently announced plans to begin reporting after-tax returns to shareholders. *Eaton Vance to Disclose After-Tax Returns*, FUND ACTION, Dec. 20, 1999, Vol. X/No. 51, at 6; Access Vanguard, *Vanguard to Publish After-Tax Returns in Equity and Balanced Fund Reports* (Oct. 11, 1999) (visited Feb. 1, 2000) <<http://www.vanguard.com/cgi-bin/pressroom/PRPrevious.html>>. Fidelity Investments and Charles Schwab & Co. also have begun offering Internet tools that feature after-tax returns of funds

addition, several fund groups have created new funds promoting the use of more tax-efficient portfolio management strategies.¹⁰ At the same time, a bill has been introduced in Congress that would require the Commission to revise its regulations to require improved disclosure of mutual fund after-tax returns.¹¹ Many press commenters also have highlighted the need for improvements in mutual fund tax disclosure.¹²

Currently, the Commission requires mutual funds to disclose significant information about taxes to investors. In its prospectus, a mutual fund is required to disclose (i) the tax consequences of buying, holding, exchanging, and selling fund shares, including the tax consequences of fund distributions; and (ii) whether the fund may engage in active and frequent portfolio trading to achieve its principal investment strategies, and, if so, the tax

offered in their fund supermarkets. Fidelity Investments, *Track After-Tax Fund Performance On-Line* (visited February 8, 2000) <<http://personal300.fidelity.com/global/whatsnew/content/94689.html.tvsr>> (after-tax returns for most equity funds sold through the fund supermarket); *Short Takes: Schwab Offering On-Line Research Access*, THE AMERICAN BANKER, Jan. 5, 2000, at 6 (after-tax returns for funds listed by Morningstar, Inc.).

Further, Morningstar, Inc., and *Forbes* report mutual fund after-tax returns. Morningstar, MUTUAL FUND 500 (1999 ed.); *Fund Survey*, FORBES, Feb. 7, 2000, at 166.

On-line tax calculators that calculate after-tax returns are also available. *Andrew Tobias' Mutual Fund Cost Calculator*, (visited Jan. 14, 2000) <<http://www.personalfund.com/cgi-bin/calculate.cgi>> (cost calculator includes a feature that calculates after-tax returns); Access Vanguard, *After-Tax Returns Calculator* (visited Jan. 19, 2000) <http://majestic3.vanguard.com/FP/DA/0.1.vgi_FundAfterTaxSim/212820070619150300?AFTER_TAX_CALC=SIMPLE>.

¹⁰ The many fund groups offering funds labeled as "tax-managed" or "tax-efficient" include American Century, Eaton Vance, Liberty Funds, Paine Webber, Prudential, T. Rowe Price, and Voyager. Morningstar, Inc., currently tracks 42 tax-managed funds, as compared to 12 such funds only three years ago. Morningstar.com, *Tax-Managed Funds Keep Uncle Sam at Bay* (visited Feb. 23, 2000) <<http://news.morningstar.com/news/ms/taxingissues/000125taxes.html>>.

¹¹ The Mutual Fund Tax Awareness Act of 1999, H.R. 1089, 106th Cong., 1st Sess. (1999) (introduced by Congressman Paul Gillmor). See also H.R. 1089: The Mutual Fund Tax Awareness Act of 1999: Hearings Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce, 106th Cong., 1st Sess. (Oct. 29, 1999) (Statement of the U.S. Securities and Exchange Commission Concerning Disclosure of the Tax Consequences of Mutual Fund Investments and Charitable Contributions).

¹² See, e.g., Karen Damato, *Funds' Tally of IRS Bite Can Be Tricky*, THE WALL STREET JOURNAL, Nov. 3, 1999, at C1; Paul J. Lim, *Your Money; Funds and 401(k)s; As Stock Market Returns Shrink, After-Tax Results Gain Importance*, LOS ANGELES TIMES, Oct. 17, 1999, at C3; Charles A. Jaffe, *Mutual Fund Gains Create Interesting Tax Issues Later*, THE KANSAS CITY STAR, Mar. 23, 1999, at D19.

consequences of increased portfolio turnover and how this may affect fund performance.¹³ A fund also must disclose in its prospectus and annual report the portfolio turnover rate and dividends and capital gains distributions per share for each of the last five fiscal years.¹⁴ While we believe this disclosure is useful, we are persuaded that funds can more effectively communicate to investors the tax consequences of investing. We are therefore proposing for public comment amendments to our rules and to Form N-1A, the registration form for mutual funds, that would require disclosure of standardized mutual fund after-tax returns.

This is the latest Commission action in our continuing effort to improve the quality of mutual fund disclosure in order to help investors make better-informed decisions. In 1998, for example, we adopted comprehensive amendments to Form N-1A in order to focus the disclosure in a fund's prospectus on essential information that will assist investors in deciding whether to invest in the fund.¹⁵ We also permitted the use of a new short-form document, the fund "profile," which summarizes key information about a mutual fund.¹⁶

Over the years, we have implemented a number of initiatives to improve fund disclosure of costs and performance. We standardized before-tax fund performance in advertisements and sales literature in order to prevent misleading performance claims by funds and to permit investors to make meaningful comparisons among funds.¹⁷ We introduced a uniform fee table in the prospectus¹⁸ and required that a fund discuss its performance over the past year in its prospectus or annual report to shareholders.¹⁹

More recently, we have increased our efforts to educate investors about mutual fund costs and how those costs

¹³ Item 7(e) of Form N-1A; Instruction 7 to Item 4 of Form N-1A.

¹⁴ Items 9(a) and 22(b)(2) of Form N-1A. These items also require funds to show net realized and unrealized gain or loss on investments on a per share basis for each of the fund's last five fiscal years.

¹⁵ Investment Company Act Release No. 23064 (Mar. 13, 1998) [63 FR 13916 (Mar. 23, 1998)] ("Form N-1A Adopting Release"), at 13917.

¹⁶ Investment Company Act Release No. 23065 (Mar. 13, 1998) [63 FR 13968 (Mar. 23, 1998)], at 13969.

¹⁷ Investment Company Act Release No. 16245 (Feb. 2, 1988) [53 FR 3868 (Feb. 10, 1988)], at 3869.

¹⁸ Item 3 of Form N-1A; Investment Company Act Release No. 16244 (Feb. 1, 1988) [53 FR 3192 (Feb. 4, 1988)].

¹⁹ Item 5(a) of Form N-1A; Investment Company Act Release No. 19382 (Apr. 6, 1993) [58 FR 19050 (Apr. 12, 1993)] ("MDFP Release").

affect performance.²⁰ Just last year, we introduced a "Mutual Fund Cost Calculator" to assist investors in determining how fund fees and charges affect their mutual fund returns.²¹

Today's proposal represents another significant step in these efforts. Taxes are one of the largest costs associated with a mutual fund investment, having a dramatic impact on the return an investor realizes from a fund. Our proposal will help investors to understand the magnitude of tax costs and compare the impact of taxes on the performance of different funds.

While the Commission recognizes that a significant amount of mutual fund assets are held through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts ("IRAs"), approximately half of non-money market fund assets held by individuals are held in taxable accounts.²² We are concerned that the millions of mutual fund investors who are subject to current taxation may not fully appreciate the impact of taxes on their fund investments because mutual funds are required to report their performance on a before-tax basis only.²³ Although performance is only

one of many factors that an investor should consider in deciding whether to invest in a particular fund, many investors consider performance one of the most significant factors when selecting or evaluating a fund.²⁴ As a result, we believe it would be beneficial for funds to provide their after-tax performance in order to allow investors to make better-informed decisions.

Our proposals would require a fund to disclose its standardized after-tax returns for 1-, 5-, and 10-year periods. After-tax returns, which would accompany before-tax returns in fund prospectuses and annual reports, would be presented in two ways: (i) assuming the shareholder continued to hold his or her shares at the end of the period; and (ii) assuming the shareholder sold his or her shares at the end of the period, realizing taxable gain or loss on the sale. Although after-tax returns would not be required in fund advertisements and sales literature, any fund choosing to include after-tax returns in these materials would be required to include after-tax returns computed according to our standardized formula.

II. Discussion

A. Requirement to Disclose After-Tax Return

The Commission is proposing to require that mutual funds disclose after-tax return, a measure of a fund's performance adjusted to reflect taxes that would be paid by an investor in the fund. The proposal would require after-tax return information to be included in the risk/return summary of the prospectus and in Management's Discussion of Fund Performance ("MDFP"), which is typically contained in the annual report.²⁵ Funds would not be required to include after-tax returns in advertisements or other sales materials, although funds choosing to include after-tax returns in sales

materials would be required to include after-tax returns computed according to a standardized formula.²⁶

We considered whether, in lieu of requiring after-tax returns to be included in prospectuses and annual reports, we should simply require that funds voluntarily choosing to include after-tax returns in any materials (prospectus, annual report, or sales materials) also include after-tax returns computed according to a standardized formula. We concluded that this approach would not achieve our basic goal of providing investors in all mutual funds with better disclosure of the tax consequences of their investments. Permitting funds to choose whether to disclose after-tax returns could leave investors without the information required to compare after-tax returns for each fund they were considering and could leave funds with the latitude to disclose this information only when it is favorable.

Funds would calculate after-tax return by using a standardized formula similar to the formula presently used to calculate before-tax average annual total return.²⁷ The proposal would require funds to disclose after-tax return for 1-, 5-, and 10-year periods on both a "pre-liquidation" and "post-liquidation" basis. Pre-liquidation after-tax return assumes that the investor continues to hold fund shares at the end of the measurement period, and, as a result, reflects the effect of taxable distributions by a fund to its shareholders but not any taxable gain or loss that would be realized by a shareholder upon the sale of fund shares.²⁸ Post-liquidation after-tax return assumes that the investor sells his or her fund shares at the end of the measurement period, and, as a result, reflects the effect of both taxable distributions by a fund to its shareholders and any taxable gain or loss realized by the shareholder upon the sale of fund shares.²⁹ Pre-liquidation after-tax return reflects the tax effects on shareholders of the portfolio manager's purchases and sales of portfolio securities, while post-liquidation after-tax return also reflects the tax effects of a shareholder's individual decision to sell fund shares.

The Commission proposes to require the presentation of both pre-and post-liquidation after-tax returns in order to provide investors with a more complete understanding of the impact of taxes on

²⁰ See, e.g., Securities and Exchange Commission, *Mutual Fund Investing: Look at More Than a Fund's Past Performance* (last modified Jan. 24, 2000) <<http://www.sec.gov/consumer/mperf.htm>>; Securities and Exchange Commission, *Invest Wisely: An Introduction To Mutual Funds* (last modified Oct. 21, 1996) <<http://www.sec.gov/consumer/inws.htm>>; "Common Sense Investing in the 21st Century Marketplace," Remarks by Arthur Levitt, Chairman, SEC, Investors Town Meeting, Albuquerque, NM (Nov. 20, 1999); "Financial Self-Defense: Tips From an SEC Insider," Remarks by Arthur Levitt, Boston Globe "Moneymatters" Personal Finance Conference, Boston, MA (Oct. 16, 1999); Transparency in the United States Debt Market and Mutual Fund Fees and Expenses: Hearings Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce, 105th Cong., 2nd Sess. (Sept. 29, 1998) (Statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission).

²¹ Securities and Exchange Commission, *The SEC Mutual Fund Cost Calculator* (last modified December 6, 1999) <<http://www.sec.gov/mfcc/mfcc-int.htm>>.

²² As of year end 1998, seventy-eight percent of mutual fund assets (\$4.3 trillion) were held by individuals. 1999 MUTUAL FUND FACT BOOK, *supra* note 1, at 41. At the end of 1998, mutual fund assets held in retirement accounts stood at \$1.9 trillion. 1999 MUTUAL FUND FACT BOOK, at 47. Mutual fund assets held by individuals in money market funds stood at \$714 billion. 1999 MUTUAL FUND FACT BOOK, at 90, 100. Thus, 47 percent of non-money market fund assets held by individuals (\$1.7 trillion) were held in taxable accounts.

An investor is not taxed on his or her investments in IRAs, 401(k) plans, and other qualified retirement plans until the investor receives a distribution from the plan. I.R.C. 401 *et seq.* See IRS Publication 564, *Mutual Fund Distributions* (1999), at 2 (explaining tax treatment of mutual funds held in retirement vehicles).

²³ See Items 2, 5, 9, and 22(b)(2) of Form N-1A.

²⁴ We recently posted a bulletin for mutual fund investors on our website, in which we cautioned investors to look beyond performance when evaluating mutual funds and to consider the costs relating to a mutual fund investment, including fees, expenses, and the impact of taxes on their investment. Securities and Exchange Commission, *Mutual Fund Investing: Look at More Than a Fund's Past Performance* (last modified Jan. 24, 2000) <<http://www.sec.gov/consumer/mperf.htm>>.

See ICI, *Understanding Shareholders' Use of Information and Advisers* (Spring 1997), at 21 and 24. (Total return information was frequently considered by investors before a purchase, second only to the level of risk of the fund. Eighty-eight percent of fund investors surveyed said that they considered total return before their most recent purchase of a mutual fund. Eighty percent of fund owners surveyed reported that they followed a fund's rate of return at least four times per year.)

²⁵ Proposed Items 2(c)(2)(i) and (iii) and 5(b)(2) of Form N-1A.

²⁶ Proposed rules 482(e)(4), 482(e)(5)(iii), and 34b-1(b)(1)(iii)(B).

²⁷ See Item 21(b)(1) of Form N-1A.

²⁸ Proposed Item 21(b)(3) of Form N-1A.

²⁹ Proposed Item 21(b)(4) of Form N-1A.

a fund's performance. The relative value of these two measures of after-tax performance is the subject of ongoing debate among industry participants. Those who support the use of pre-liquidation after-tax return argue that pre-liquidation after-tax return provides the most relevant information for analyzing the tax impact of decisions by the portfolio manager.³⁰ Others argue that this measure of after-tax return, taken alone, tends to overstate the benefits of tax deferral on shareholder gains.³¹

We believe that pre-liquidation after-tax return is important because it provides information about the tax-efficiency of portfolio management decisions. We also believe, however, that it is important for shareholders, many of whom hold shares for a relatively brief period, to understand the full impact that taxes have on a mutual fund investment that has been sold.³² Therefore, we are proposing to require funds to disclose both measures of after-tax return.

We are proposing that funds reflect the deduction of any fees and charges payable upon a sale of fund shares, such as sales charges or redemption fees, in post-liquidation after-tax returns but not in pre-liquidation after-tax returns.³³ This is consistent with the fact that post-liquidation after-tax returns assume a sale of fund shares by the investor, while pre-liquidation after-tax returns do not. Funds are currently required to disclose before-tax returns reflecting the deduction of any fees and charges payable upon a sale of fund shares.³⁴ These before-tax returns may usefully be

compared to the post-liquidation after-tax return measure that we are proposing (because both types of returns reflect fees and charges payable upon a sale of fund shares), but they may not usefully be compared to the pre-liquidation after-tax return measure that we are proposing (which does not reflect fees and charges payable upon sale of fund shares).

We are therefore proposing to require that funds also disclose before-tax returns that do not reflect the deduction of fees and charges payable upon a sale of fund shares. This would provide investors with a before-tax return measure that can be compared with the pre-liquidation after-tax return measure that we are proposing.³⁵ In the alternative, we considered requiring that pre-liquidation after-tax return reflect the deduction of any fees and charges payable upon a sale of fund shares. Pre-liquidation after-tax return computed in this way could usefully be compared to the before-tax return that is currently required to be disclosed, but we were concerned that investors would be confused by a pre-liquidation after-tax return measure that assumed no sale of fund shares for purposes of computing tax consequences but nonetheless reflected fees and charges payable upon a sale of fund shares.

Commenters are requested to discuss whether we should require disclosure of after-tax returns. Is this information useful to, and understandable by, investors? Commenters are asked to address the relative merits of requiring disclosure of after-tax returns versus standardizing the computation of after-tax returns for funds that choose to disclose after-tax returns. Should disclosure be mandatory only for funds that hold themselves out as "tax-managed" or otherwise managed with a view to shareholder tax consequences?

Should we require disclosure of both pre-liquidation and post-liquidation after-tax returns or is disclosure of one of these measures sufficient? Commenters also are requested to discuss how we should address the issue of providing a useful comparison for pre-liquidation after-tax returns. Should we, as proposed, require the disclosure of before-tax return that does not reflect the deduction of any fees and charges payable upon a sale of fund shares? Or should we require funds to reflect the deduction of any fees and charges payable upon a sale of fund shares in pre-liquidation after-tax returns or take some other approach? Finally, commenters are asked to

address whether we should require disclosure of after-tax returns for an index or a peer group of funds.

B. Location of Required Disclosure

The proposal would require mutual funds to disclose after-tax returns in the performance table contained in the risk/return summary of the prospectus and in the MDFFP, which is typically contained in the annual report.³⁶ The proposal also would have the effect of requiring the inclusion of after-tax returns in any fund profile because a profile must include the prospectus risk/return summary.³⁷

We are proposing to require that after-tax returns be included in the prospectus because, for the overwhelming majority of prospective investors who base their investment decision, in part, on past performance, after-tax returns can be useful in understanding past performance.³⁸ Including after-tax returns in the performance table of the risk/return summary would assist prospective investors in their investment decisions by making after-tax returns easy to find and easy to compare with before-tax returns, which are currently presented in this location.³⁹

We are proposing to include after-tax returns in the MDFFP because, for existing shareholders, after-tax returns are an important element to consider when evaluating fund performance.⁴⁰

³⁶ Proposed Items 2(c)(2)(iii) and 5(b)(2) of Form N-1A.

³⁷ Rule 498(c)(2)(iii) under the Securities Act [17 CFR 230.498(c)(2)(iii)]. In addition, after-tax returns would be required in registration statements filed on Form N-14 [17 CFR 239.23], the registration form used by mutual funds to register securities to be issued in mergers and other business combinations under the Securities Act. See Items 5(a) and 6(a) of Form N-14 (cross-referencing Items 2 and 5 of Form N-1A).

³⁸ An estimated 88 percent of mutual fund shareholders considered the total return of the fund before their most recent fund purchase. Seventy-five percent of mutual fund shareholders considered the fund's performance relative to similar funds. ICI, UNDERSTANDING SHAREHOLDERS' USE OF INFORMATION AND ADVISERS (Spring 1997), at 21.

³⁹ Item 2(c)(2)(iii) of Form N-1A.

⁴⁰ Eighty percent of mutual fund shareholders monitor the performance of their fund holdings at least four times per year. ICI, UNDERSTANDING SHAREHOLDERS' USE OF INFORMATION AND ADVISERS (Spring 1997), at 24.

Form N-1A requires that the prospectus include the MDFFP unless the information is included in the fund's latest annual report to shareholders and the fund provides a copy of the annual report, upon request and without charge, to each person to whom a prospectus is delivered. Item 5 of Form N-1A. A significant majority of funds currently include the MDFFP in their annual reports to shareholders. The Commission has directed the Division of Investment Management to draft proposed amendments to fund periodic reporting requirements, and has asked that, in connection

³⁰ See H.R. 1089: The Mutual Fund Tax Awareness Act of 1999: Hearings Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce, 106th Cong., 1st Sess. (Oct. 29, 1999) (Statement of Joel M. Dickson, Principal, The Vanguard Group, Inc.) (stating that "the primary advantage of the pre-liquidation calculation is that it isolates the effects on all shareholders of the taxes resulting from the portfolio manager's investment decisions").

³¹ See H.R. 1089: The Mutual Fund Tax Awareness Act of 1999: Hearings Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce, 106th Cong., 1st Sess. (Oct. 29, 1999) (Statement of David B. Jones, Vice President, Fidelity Management & Research Co.) (stating that "pre-liquidation returns risk fostering the impression that taxes can be deferred indefinitely, which is not the case for most investors; and tend to exaggerate the benefits of tax deferral").

³² A recent report estimates that over the past decade the average holding period of mutual funds has decreased from over 10 years to about 3 years. Steve Galbraith, Mary Medley, Sean Yu, The Apotheosis of Stuart—Lighting the Candle in U.S. Equities, Bernstein Research Call, Sanford C. Bernstein & Co., Jan. 10, 2000.

³³ Instruction 6 to proposed Item 21(b)(4) and Instruction 6 to proposed Item 21(b)(3) of Form N-1A.

³⁴ Instruction 4 to Item 21(b)(1) of Form N-1A.

³⁵ Proposed Items 2(c)(2)(iii)(A), 5(b)(2)(i), and 21(b)(1) of Form N-1A.

The Commission added the MDFP requirement in response to investor concerns that mutual funds did not provide sufficient information to permit investors readily to evaluate fund investment results.⁴¹ Including after-tax returns as part of the MDFP presentation will enhance its usefulness.

We have considered alternative locations for disclosure of after-tax returns, including: (i) The bar chart in the risk/return summary; (ii) the section of the prospectus describing the tax consequences to shareholders of buying, holding, exchanging, and selling fund shares; and (iii) the financial highlights table, which appears in both prospectuses and annual reports.⁴² Each of these other locations, however, presents some drawbacks that resulted in our decision not to propose it as the location for after-tax returns.

The bar chart is prominently located in the prospectus, but it is intended to reflect fund volatility, not overall fund performance.⁴³ In addition, the performance shown in the bar chart does not reflect the deduction of sales loads or account fees and is presented for only a single class of a multiple class fund.⁴⁴ Although the tax section of the prospectus could provide a centralized

location for tax information, inclusion of after-tax returns in this section would make them far less prominent than the before-tax returns included in the risk/return summary. The financial highlights table contains other tax information, such as dividends, capital gain distributions, and portfolio turnover rate.⁴⁵ On the other hand, the financial highlights table is not as prominently located in the prospectus as the risk/return summary. Further, the information presented in the financial highlights table is presented on a year-by-year basis, rather than on the average annual return basis over 1-, 5-, and 10-year periods that is used in computing standardized before-tax returns.

We also have considered vehicles other than the prospectus and annual reports for the disclosure of after-tax returns, including:

- Requiring disclosure of after-tax returns in the Statement of Additional Information (“SAI”);
- Providing funds with the option of disclosing after-tax returns on their Internet website in lieu of including after-tax returns in the prospectus or annual report; and

- Permitting funds to provide after-tax returns upon shareholder request only.

We determined not to propose any of these approaches because each would place the burden of obtaining after-tax return information on the investor, which could greatly reduce investors’ receipt of this useful information.

Comment is requested on the appropriate location for disclosure of after-tax returns and how best to convey this information to both existing and prospective investors. Should this information be included in the prospectus, annual report, profile, or elsewhere? Commenters are asked to address the specific location in any document where this information should be included (*e.g.*, risk/return summary, MDFP) and the advantages and disadvantages of the suggested location. Commenters should address the locations discussed in this release and any other locations that they believe would be appropriate.

C. Format of Disclosure

We are proposing that before and after-tax returns be presented in a standardized tabular format as follows:⁴⁶

AVERAGE ANNUAL TOTAL RETURNS
[For the periods ended —]

	1 year	5 years	10 years
If You Continue to Hold Your Shares at End of Period:			
Before-Tax Return	__%	__%	__%
After-Tax Return	__%	__%	__%
If You Sell Your Shares at End of Period:			
Before-Tax Return	__%	__%	__%
After-Tax Return	__%	__%	__%
Index (reflects no deduction for fees, expenses, or taxes)	__%	__%	__%

Before-and after-tax returns would be required to be presented in the order specified, using the captions provided by Form N-1A.⁴⁷ The table of returns would be required for each class of a fund offered in the prospectus. The four types of return for each class would be required to be presented adjacent to one another and not interspersed with the returns of other classes or funds.⁴⁸ This should facilitate comparisons among the returns shown.

We considered giving funds flexibility to create different formats for presenting the required information. We elected not to propose this alternative because of potential investor confusion. We believe that it would be easier for shareholders both to compare funds and to understand the differences among the different measures of return for any particular fund if all funds present this information in the same manner, using the same captions. Commenters are requested to address whether the

Commission should require that before-and after-tax return information be presented in a specific format, using required captions. Does the proposed table present before-and after-tax return information in a clear and understandable way? Do the proposed captions adequately describe the information presented? Will investors be able to understand the presentation for funds with multiple classes and multiple portfolios? Is there a more

with such a proposal, the Division consider whether the MDFP would be more useful to investors in shareholder reports. Form N-1A Adopting Release, *supra* note 15, at 13929.

⁴¹ MDFP Release, *supra* note 19, at 19052.
⁴² Items 2(c)(2), 7(e), and 9 of Form N-1A.

⁴³ Item 2(c)(2)(i) of Form N-1A; Form N-1A Adopting Release, *supra* note 15, at 13922.

⁴⁴ Instructions 1 and 3 to Item 2(c)(2) of Form N-1A.

⁴⁵ Item 9 of Form N-1A.

⁴⁶ Proposed Items 2(c)(2)(iii) and 5(b)(2) of Form N-1A.

Although the proposed performance table in the prospectus risk/return summary includes the return of a broad-based securities market index as shown in the text, the table required in the MDFP does not.

The MDFP includes the performance of a broad-based securities market index in the line graph that accompanies the table. *See* proposed Item 2(c)(2)(iii) of Form N-1A; Item 5(b)(1) of Form N-1A.

⁴⁷ Proposed Items 2(c)(2)(iii) and 5(b)(2) of Form N-1A.

⁴⁸ Instruction 3(c) to proposed Item 2 and Instruction 12 to proposed Item 5 of Form N-1A.

effective way to present after-tax returns for these funds?

D. Exemptions from the Disclosure Requirement

We are proposing to exempt money market funds from the requirement to disclose after-tax returns.⁴⁹ We are also proposing to permit a fund that is offered as an investment option in a participant-directed defined contribution plan or variable insurance contract to omit the after-tax return information in a prospectus for use by participants in the plan or owners of the contract.⁵⁰

Money market funds typically do not accumulate or distribute capital gains and their returns are generally in the form of income distributions, which are taxable on a current basis. As a result, the tax consequences of investing in different money market funds should be similar, *i.e.*, current taxation on income distributions. For this reason, requiring money market funds to disclose after-tax returns would not significantly assist an investor in comparing different money market funds. In addition, it could place money market funds at a competitive disadvantage vis-a-vis competing financial products, such as bank savings accounts and certificates of deposit, that are not required to disclose after-tax returns. For these reasons, we have determined not to extend to money market funds the requirement to disclose after-tax returns.

We also are proposing to permit a fund to omit the after-tax return information in a prospectus used exclusively to offer fund shares as investment options for:

- A defined contribution plan that meets the requirements for qualification under section 401(k) of the Internal Revenue Code (“Code”);
- A tax-deferred arrangement under section 403(b) or 457 of the Code;
- A variable insurance contract as defined in section 817(d) of the Code, if covered in a separate account prospectus; or
- 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.⁵¹

⁴⁹ Proposed Item 2(c)(2)(iii) of Form N-1A. Money market funds are already exempted from the requirements of Item 5 of Form N-1A.

⁵⁰ Proposed General Instruction C.3(d)(i) of Form N-1A. The proposed instruction would permit a fund to omit from its prospectus the information required by Items 2(c)(2)(iii)(A), (B), and (D), and 2(c)(2)(iv), 5(b)(2)(i), (ii), and (iv), and 5(b)(3) if the fund’s prospectus will be used exclusively to offer fund shares as investment options in specified types of plans.

⁵¹ *Id.* We propose expanding the types of prospectuses that may omit or modify certain

The proposed after-tax return information would largely be irrelevant to investors in those arrangements because they are not subject to current taxation on fund distributions and their tax consequences on a sale of fund shares are different than those experienced by investors in taxable accounts.⁵²

The Commission considered whether to exclude tax-exempt funds from the requirement to disclose after-tax returns.⁵³ While most, if not all, income distributed by a tax-exempt mutual fund generally will be tax-exempt, a tax-exempt mutual fund may also make capital gains distributions that are taxable and an investor is taxable on gains from the sale of fund shares.⁵⁴ As a result, the performance of a tax-exempt fund may be affected by taxes and taxes may have a greater or lesser impact on different tax-exempt funds. Therefore, we have not proposed to exclude tax-exempt funds from the required disclosure.⁵⁵

information required by Form N-1A to include prospectuses used to offer fund shares as investment options for plans or arrangements similar to those currently enumerated in General Instruction C.3.(d)(i) of Form N-1A. Proposed General Instruction C.3(d)(i)(D) of Form N-1A. We are proposing this change in order to accommodate future changes in the tax law that may permit new types of plans or arrangements similar to those currently enumerated in the instruction.

⁵² See IRS Publication 575, *Pension and Annuity Income* (1999), at 4 (explaining tax treatment of earnings under a variable annuity contract) and 8-19 (explaining tax treatment of distributions from retirement plans); IRS Publication 525, *Taxable and Non-Taxable Income* (1999), at 3 (explaining tax treatment of contributions to a retirement plan) and 22 (explaining tax treatment of proceeds of a life insurance contract); IRS Publication 575, *Pension and Annuity Income* (1999), at 4 (tax treatment of Section 457 Deferred Compensation Plan); IRS Publication 571, *Tax Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations* (1999), at 2 (explaining tax treatment of Section 403(b) tax sheltered annuities).

⁵³ The Division of Investment Management has taken the position that an investment company with a name that implies that its income distributions will be exempt from federal income taxation should have a fundamental policy requiring that during periods of normal market conditions (i) the fund will have at least 80 percent of its net assets in tax-exempt securities or (ii) the fund’s assets will be invested so that at least 80 percent of the income will be tax-exempt. The Commission has proposed to codify this position. Investment Company Act Release No. 22530 (Feb. 27, 1997) [62 FR 10955 (Mar. 10, 1997)], correction [62 FR 24161 (May 2, 1997)], at 10958.

⁵⁴ Interest on any state or local bond is excluded from gross income. However, there is no exclusion for capital gains resulting from the sale of such bonds. See I.R.C. 103(a); IRS Publication 564, *Mutual Fund Distributions* (1999), at 2 (describing tax treatment of tax-exempt mutual funds).

⁵⁵ A tax-exempt fund, like any other fund, may assume, when calculating after-tax returns, that no taxes are due on the portions of any distribution that would not result in federal income tax on an individual. Instruction 3 to proposed Item 21(b)(3) and Instruction 3 to proposed Item 21(b)(4) of Form N-1A.

We request that commenters discuss whether the proposed exemptions from the after-tax return disclosure requirements are appropriate. Should tax-exempt funds or any other types of funds be exempted from the requirements?

E. Advertisements and Other Sales Literature

The Commission is proposing to require that all fund advertisements and sales literature that include after-tax performance information also include after-tax returns computed according to the standardized formulas prescribed in Form N-1A for computation of after-tax returns in the risk/return summary and MDFP.⁵⁶ Any quotation of non-standardized after-tax return also would be subject to the same conditions currently applicable to quotations of non-standardized performance that are included in fund advertisements and sales literature.⁵⁷ Requiring advertisements and sales literature that include after-tax returns also to include standardized pre-and post-liquidation after-tax returns is intended to prevent advertisements and sales literature from being misleading and to permit shareholders to compare claims about after-tax performance.

Comment is requested regarding the inclusion of after-tax returns in fund advertisements and other sales literature. Is the proposed requirement to disclose standardized after-tax returns in any advertisement or other sales literature containing after-tax

⁵⁶ Proposed rule 482(e)(4) would permit the standardized after-tax returns for 1-, 5-, and 10-year periods to be contained in an advertisement, provided that the standardized after-tax returns (i) are current to the most recent calendar quarter ended prior to the submission of the advertisement for publication; (ii) are accompanied by quotations of standardized before-tax return; (iii) include both pre-and post-liquidation standardized after-tax returns; (iv) are set out with equal prominence to one another and in no greater prominence than the required quotations of standardized before-tax return; and (v) identify the length of and the last day of the 1-, 5-, and 10-year periods.

Any other measures of after-tax return could be included in advertisements if accompanied by the standardized measures of after-tax return. Proposed rule 482(e)(5)(iii). Similarly, measures of after-tax return could be included in other sales materials if accompanied by the standardized measures of after-tax return. Proposed rule 34b-1(b)(1)(iii)(B).

⁵⁷ Specifically, any measure of after-tax return in a rule 482 advertisement would have to reflect all elements of return and could be set out in no greater prominence than the required quotations of standardized before-tax and after-tax returns. The advertisement would have to identify the length of and the last day of the period for which performance is measured. Proposed rule 482(e)(5)(i), (iv), and (v).

In addition, any sales literature that contains a quotation of performance that has been adjusted to reflect the effect of taxes would remain subject to the other requirements of rule 34b-1.

returns appropriate? Should any funds be exempted from this requirement? Commenters are also requested to address whether the Commission should require that all fund advertisements and sales literature that include any quotation of performance, including before-tax performance, include standardized after-tax returns.

F. Formulas for Computing After-Tax Return

Our proposals would require that funds compute after-tax returns using standardized formulas that are based largely on the current standardized formula for computing before-tax average annual total return.⁵⁸ 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 payment.⁵⁹ Also, after-tax average annual total returns would be calculated for 1-, 5-, and 10-year periods.⁶⁰

The computation of after-tax return depends on several assumptions, such as tax bracket, that vary from investor to investor. As a result, the proposed standardized after-tax return measures are not intended as precise computations of any individual investor's after-tax returns from a fund, but as guides to understanding the effect of taxes on the fund's performance. In this regard, the proposed standardized after-tax return measures are similar to the standardized before-tax returns, which also are dependent on assumptions such as the purchase and sale date of fund shares, and do not precisely measure an individual investor's before-tax returns. The Commission believes that the presentation of standardized after-tax returns, coupled with the presentation of standardized before-tax returns, will provide investors with a more complete and accurate picture of a fund's performance than the before-tax returns standing alone.

The assumptions that the Commission proposes to require funds to use in calculating after-tax returns are described in this section. Commenters are asked to discuss any aspect of the proposed formulas for computing after-

tax returns, including the proposed assumptions and whether other assumptions would be more appropriate. Commenters are asked to quantify the significance of different assumptions.

1. Tax Bracket

We are proposing that standardized after-tax returns be calculated assuming that distributions and gains on a sale of fund shares are taxed at the highest applicable individual federal income tax rate.⁶¹ Computing after-tax returns with maximum tax rates will provide investors with the "worst-case" federal income tax scenario. Coupled with before-tax returns that reflect the imposition of taxes at a 0% rate, this "worst-case" scenario will effectively provide investors with the full range of historical after-tax returns. Short of providing investors with after-tax returns computed at each tax rate, which we have decided not to propose because of the complexity of the resulting disclosure, we believe that providing investors with the full range of federal income tax outcomes (0% and maximum rate) would provide investors the most complete information. In reaching this conclusion, we looked for guidance to current industry practice. Both funds and third party providers of information that provide after-tax performance information to investors frequently use the highest tax rates when calculating after-tax return.⁶²

We considered proposing that after-tax returns be presented using intermediate tax rates in order to approximate the rates paid by typical

mutual fund investors.⁶³ We decided not to propose this approach because it would not provide information regarding the maximum impact that federal income taxes could have on a fund's return and because of the complexity of determining the appropriate intermediate rate from one year to the next as tax brackets and tax rates change. We also considered proposing that after-tax returns be presented using multiple rates, but rejected this approach because it would result in a fairly complex table of returns that could be overwhelming.

We request comment on our proposal to use maximum tax rates to compute after-tax returns. Are there preferable alternatives? Commenters who believe that maximum tax rates should not be used because they are higher than the rates paid by typical mutual fund investors are asked to address whether their concerns are mitigated by our decision not to reflect state and local taxes, which will tend to result in an understated overall tax burden.⁶⁴ Commenters are asked to address whether the after-tax performance rankings of funds relative to each other depend on the tax rates used to compute returns and, if so, to indicate how this should affect the rate adopted by the Commission for the computation of after-tax returns. Commenters who favor the use of an intermediate rate should specify how the rate should be selected and how the rate should be established each year. Commenters who favor the use of multiple rates should suggest a format for presenting the resulting table of returns.

2. Historical versus Current Tax Rates

The Commission is proposing to require funds to calculate after-tax returns for 1-, 5-, and 10-year periods using the historical tax rates that were in effect during these periods, rather than the rates that are in effect at the time the computation is performed.⁶⁵ The use of historical rates will more accurately reflect a fund's actual after-tax returns. Moreover, to the extent that a fund has been managed in response to the then-current tax environment, it seems most appropriate to judge the effectiveness of the management strategy by applying tax rates that were

⁶¹ Instruction 4 to proposed Item 21(b)(3) of Form N-1A; Instructions 4 and 7(d) to proposed Item 21(b)(4) of Form N-1A.

Currently, the highest individual marginal income tax rate imposed on ordinary income is 39.6%, and the highest rate imposed on long-term capital gains is 20%. I.R.C. 1(a)-(d), (h).

⁶² See, e.g., Access Vanguard, *Vanguard to Publish After-Tax Returns in Equity and Balanced Fund Reports* (Oct. 11, 1999) (visited Feb. 1, 2000) <<http://www.vanguard.com/cgi-bin/pressroom/PRPrevious.html>>; Fidelity Investments, *Track After-Tax Fund Performance On-Line* (visited Feb. 1, 2000) <<http://personal400.fidelity.com/global/whatsnew/content/94689.html.tvsr/>>; Morningstar, *MUTUAL FUND 500* (1999 ed.); Catherine Voss Sanders, *Making April Less Taxing*, 5 *MORNINGSTAR INVESTOR*, Feb. 1997; Association for Investment Management and Research, *AIMR PERFORMANCE PRESENTATIONS STANDARDS HANDBOOK* (2d ed. 1997), at 59; *Mutual Fund Scoreboard*, Business Week, Feb. 1, 1999. But see *The Ultimate Mutual Fund Guide 2000*, MONEY, Feb. 2000, at 64 (reporting mutual fund tax-efficiency calculated based on the return of an investor in the 28 percent federal tax bracket); *Fund Survey*, FORBES, Feb. 7, 2000, at 166 (reporting after-tax returns reflecting "the tax liability of an upper-middle income investor").

⁶³ The median income of mutual fund shareholders is approximately \$ 55,000. ICI, 1998 *Profile of Mutual Fund Investors* (Summer 1999). An individual taxpayer with taxable income over \$25,750 but not over \$62,450 is taxed at a marginal rate of 28 percent. I.R.C. 1(c).

⁶⁴ See discussion below at II.F.4 (State and Local Tax Liability).

⁶⁵ Instruction 4 to proposed Item 21(b)(3) and Instructions 4 and 7 to proposed Item 21(b)(4) of Form N-1A.

⁵⁸ Item 21(b)(1) of Form N-1A. Under the proposal, before-and after-tax returns included in the risk/return summary and the MDFP would be calculated as provided in proposed Item 21(b)(1)-(4) of Form N-1A. Instruction 2(a) to proposed Item 2 and proposed Item 5(b)(2) of Form N-1A.

⁵⁹ Proposed Items 21(b)(3) and 21(b)(4) of Form N-1A; Instruction 1 to proposed Item 21(b)(3) and Instruction 1 to proposed Item 21(b)(4) of Form N-1A.

⁶⁰ Proposed Items 21(b)(3) and 21(b)(4) of Form N-1A.

in place at the time. In addition, if current rates were used, the historical after-tax returns for previous periods

would effectively change every time the current rates change.

Under our proposal, the rates to be used for computing after-tax returns for

the most recent ten complete calendar years and the current calendar year would be as follows:

MAXIMUM INDIVIDUAL INCOME TAX RATES
[1990–2000]

Year	Long-term gains ⁶⁶ (Percent)	Mid-term gains	Short-term gains/or- ordinary income (Percent)
2000	20	.....	39.6
1999	20	.....	39.6
1998	20	.....	39.6
7/29/97–12/31/97	20	28	39.6
5/7/97–7/28/97	20	.....	39.6
1/1/97–5/6/97	28	.....	39.6
1996	28	.....	39.6
1995	28	.....	39.6
1994	28	.....	39.6
1993	28	.....	39.6
1992	28	.....	31
1991	28	.....	31
1990	28	.....	33

We request comment on the advantages and disadvantages of using historical or current tax rates in computing after-tax return. We also request comment on whether the above table accurately states the highest tax rates for the periods and categories specified. The Commission anticipates that, if we adopt a rule requiring disclosure of after-tax returns using maximum historical rates, it will not be necessary for the Commission to publish the rates for future years. Is there any reason why it would be necessary for us to publish those rates?

3. Calendar versus Fiscal Year Measurement Period

Under the proposal, after-tax returns that appear in a fund's performance table in the risk/return summary would be calculated based on calendar-year periods, consistent with the before-tax return disclosure that currently appears in the risk/return summary.⁶⁷ After-tax returns that appear in the MDFP would be calculated on a fiscal year basis, consistent with the before-tax return disclosure that currently appears in the

⁶⁶ I.R.C. 1; Standard Federal Tax Reports, 99 Index (CCH) 144, ¶ 601.

The holding period for long-term gains is more than 12 months, except for the period from July 29, 1997, through December 31, 1997, when it was more than 18 months. During that period, a "mid-term" capital gains rate applied if property was held more than 12 months but not more than 18 months. See I.R.C. 1222 (defining short-and long-term capital gain); IRS Publication 564, *Mutual Fund Distributions* (1997), at 9; IRS Publication 564, *Mutual Fund Distributions* (1998), at 1 (describing changes in holding periods in 1997).

⁶⁷ Proposed Item 2(c)(2)(iii) of Form N-1A; Item 2(c)(2)(iii) of Form N-1A (calendar-year disclosure of before-tax returns in risk/return summary).

MDFP.⁶⁸ We believe that this presentation would facilitate investor comparisons of before-tax and after-tax returns.

Comment is requested on our proposal to require calendar year after-tax returns in the risk/return summary and fiscal year after-tax returns in the MDFP. Commenters who believe the proposal should be modified should address whether similar modifications should be made in the presentation of before-tax returns. Will the use of either the fiscal year or the calendar year encourage funds to "time" distributions or portfolio transactions in any way to artificially enhance the after-tax returns presented?

4. State and Local Tax Liability

In order to simplify the computation and presentation of after-tax returns, we propose to exclude state and local tax liability although this will tend to result in after-tax returns that are somewhat overstated.⁶⁹ State and local tax rates

⁶⁸ Proposed Item 5(b)(2) of Form N-1A; Item 5(b)(2) of Form N-1A (fiscal year disclosure of before-tax returns in MDFP).

⁶⁹ Instruction 4 to proposed Item 21(b)(3) and Instruction 4 to proposed Item 21(b)(4) of Form N-1A.

In general, funds and third parties that provide investors with information regarding after-tax returns do not reflect the effect of state and local taxes on return. See, e.g., Access Vanguard, *Vanguard to Publish After-Tax Returns in Equity and Balanced Fund Reports* (Oct. 11, 1999) (visited Feb. 1, 2000) <<http://www.vanguard.com/cgi-bin/pressroom/PRPrevious.html>>; Fidelity Investments, *Track After-Tax Fund Performance On-Line* (visited Feb. 1, 2000) <<http://personal400.fidelity.com/global/whatsnew/content/94689.html.tvsr>>; Association for Investment Management and Research, AIMR PERFORMANCE PRESENTATIONS STANDARDS HANDBOOK (2d

vary widely, and there is no single tax rate that could serve as a reasonable proxy for the state and local tax burden.⁷⁰ Presentation of separate after-tax returns for all 50 states and the District of Columbia would be overwhelming for investors and burdensome for funds.

We request comment on whether the after-tax return calculations should reflect the effect of state and local taxes. Commenters who support adjusting after-tax returns for state and local taxes should address how that should be done. Commenters also should address alternative means, such as narrative disclosure, by which funds can convey to investors the impact of state and local taxes.

5. Federal Alternative Minimum Tax and Phaseout Adjustments

Tax law provides favored treatment to certain kinds of income and expenses. Taxpayers who benefit from this special treatment may be subject to at least a minimum amount of tax through the "alternative minimum tax."⁷¹ In addition, certain tax credits, exemptions, and deductions are phased out for taxpayers whose adjusted gross

ed. 1997) at 59; Morningstar, *MUTUAL FUND 500* (1999 ed.); *Fund Survey*, FORBES, Feb. 7, 2000, at 166.

⁷⁰ Some states, such as Alaska, Florida, and Nevada, charge no personal income tax, while other states impose taxes at rates as high as 12%. See Federation of Tax Administrators, *State Individual Income Tax Rates*, (visited Jan. 14, 2000) <http://www.taxadmin.org/fta/rate/ind_inc.html>.

⁷¹ I.R.C. 55. See IRS Publication 17, *Your Federal Income Tax* (1999), at 203 (explaining the effect of the alternative minimum tax).

income is above a specified amount.⁷² The proposed after-tax return formulas would not take into account the effect of either the alternative minimum income tax or phaseouts.⁷³

We believe that 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. Comment is requested regarding whether the after-tax return formulas should reflect the impact of the alternative minimum tax, the phaseouts, or any other taxes or adjustments not reflected in the proposed formulas.

6. Timing and Method of Tax Payment

The proposed after-tax return calculations would assume that any taxes due on a distribution are paid out of that distribution at the time the distribution is reinvested and would reduce the amount reinvested.⁷⁴ We have chosen this method to simplify the calculations, although we recognize that many investors do not pay income taxes out of the corresponding distributions. For example, a taxpayer might pay his or her taxes out of a bank account, either on estimated tax payment due dates or on April 15 of the year following the tax year. Or a taxpayer might pay taxes by redeeming fund shares at the time a tax payment is due. We request comment on how the after-tax return formulas should reflect the timing and method of tax payment. Commenters favoring methods other than that proposed should specify in detail how the proposed formula should be modified to reflect those methods.

7. Tax Treatment of Distributions

The proposed after-tax return formulas would require that the taxable amount and tax character (e.g., ordinary income, short-term capital gain, long-term capital gain) of each distribution be as specified by the fund on the dividend

⁷² E.g., I.R.C. 151(d)(3) (phaseout of personal exemptions). See IRS Publication 501, *Exemptions, Standard Deduction and Filing Information* (1999).

⁷³ Proposed Instruction 4 to Item 21(b)(3) and proposed Instruction 4 to Item 21(b)(4) of Form N-1A.

⁷⁴ Instruction 2 to proposed Item 21(b)(3) and Instruction 2 to proposed Item 21(b)(4) of Form N-1A.

This methodology is generally consistent with that used by industry participants. See, e.g., Morningstar, *MUTUAL FUND 500* (1999 ed.); Fidelity Investments, *Track After-Tax Fund Performance On-Line* (visited Feb. 1, 2000) <<http://personal400.fidelity.com/global/whatsnew/content/94689.html.tvsr>>; Access Vanguard, *Vanguard After-Tax Return Calculator* (visited Feb. 1, 2000) <http://majestic2.vanguard.com/FP/DA/0.1.vgi_Fund After Tax Sim/092110731601095233? AFTER_TAX_CALC=SIMPLE>.

declaration date, adjusted to reflect subsequent recharacterizations. Tax-exempt interest and non-taxable returns of capital would be assumed to result in no taxes.⁷⁵

We have not proposed to specify in detail the tax consequences of fund distributions or other features having more complicated tax characteristics (e.g., distributions derived from REIT income, distributions derived from commodities gains, foreign tax credits or deductions that pass through with respect to foreign source income). Funds should determine the tax consequences of such distributions or features by applying the tax law in effect on the date the distribution is reinvested. Commenters are requested to address whether the formula for calculating after-tax returns should be more specific in any way.

8. Capital Gains and Losses Upon a Sale of Fund Shares

The proposal would require that post-liquidation after-tax return be computed assuming a complete sale of fund shares at the end of the 1-, 5-, or 10-year measurement period, resulting in capital gains taxes or a tax benefit from any resulting capital losses.⁷⁶ In computing the taxes from any gain or the tax benefit from any loss, the rate used would be required to correspond to the tax character of the capital gain or loss (e.g., short-term or long-term). The tax character of the capital gain or loss would be determined by the length of the measurement period (1, 5, or 10 years) in the case of the initial \$1,000 investment and the length of the period between the reinvestment and the end of the measurement period in the case of reinvested distributions.⁷⁷ A fund

⁷⁵ Instruction 3 to proposed Item 21(b)(3) and Instruction 3 to proposed Item 21(b)(4) of Form N-1A.

⁷⁶ Instructions 6 and 7 to proposed Item 21(b)(4) of Form N-1A.

The capital gain or loss on the sale of fund shares would be computed by subtracting the tax basis from the redemption proceeds. Instruction 7(a) to proposed Item 21(b)(4) of Form N-1A. The tax basis would include the \$1,000 initial payment and reinvested distributions, net of taxes assumed paid from the distributions, but not net of any sales loads imposed upon reinvestment. In addition, the tax basis would be adjusted for any distributions representing returns of capital and any other tax basis adjustments applicable to an individual taxpayer. Instruction 7(b) to proposed Item 21(b)(4) of Form N-1A.

⁷⁷ Instruction 7(d) to proposed Item 21(b)(4) of Form N-1A.

We note that, in computing post-liquidation returns for a one-year period, all gains realized upon a sale of fund shares at the end of the one-year period would be short-term. See I.R.C. 1222(1) (providing that the term "short-term capital gain" means "gain from the sale or exchange of a capital asset held for not more than 1 year, if and to the

would therefore be required to track the actual holding periods of reinvested distributions and could not assume that they have the same holding period as the initial \$1,000 investment.⁷⁸

The tax laws limit the extent to which a fund shareholder may deduct capital losses when the taxpayer does not have offsetting gains.⁷⁹ In order to simplify the computation of post-liquidation after-tax returns, we are proposing to allow funds to assume that a taxpayer has sufficient capital gains of the same character to offset any capital losses upon a sale of fund shares and therefore that the taxpayer may deduct the entire capital loss.⁸⁰

Commenters are requested to discuss the proposed computation of capital gains taxes and the tax benefits from capital losses on a sale of fund shares. Should funds be required to track the actual holding periods of reinvested distributions, as proposed, or should they be permitted to assume that reinvested distributions have the same holding period as the initial \$1,000 investment? Should capital losses on a sale of fund shares be permitted to be deducted in full, or should the deduction be limited in some way?

G. Narrative Disclosure

The proposal would require funds to include a short, explanatory narrative adjacent to the performance table in the risk/return summary and the MDFP.⁸¹ This is intended to facilitate investor

extent such gain is taken into account in computing gross income").

⁷⁸ Instruction 7(c) to proposed Item 21(b)(4) of Form N-1A.

⁷⁹ Under the Code, when calculating taxable income, an investor may fully offset short-term capital gains with short-term capital losses and fully offset long-term capital gains with long-term capital losses. Net short-term capital gain or loss may then be offset against net long-term capital gain or loss. If capital gains exceed capital losses, the investor is taxed on the difference at a rate that is determined by whether the net gain is short- or long-term. If capital losses exceed capital gains, the difference may be deducted from ordinary income, subject to a yearly limit of \$3,000. I.R.C. 1211(b)(2) (providing that in the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of \$3,000 (\$1,500 in the case of a married individual filing a separate return) or the excess of such losses over such gains.) See IRS Publication 544, *Sales and Dispositions of Assets* (1999), at 30 (explaining tax treatment of capital gains and losses).

⁸⁰ Instruction 7(d) to proposed Item 21(b)(4) of Form N-1A.

⁸¹ Proposed Items 2(c)(2)(iv) and 5(b)(3) of Form N-1A.

The line graph in the MDFP also would be required to be accompanied by a statement to the effect that the account value shown in the graph does not reflect the taxes that a shareholder would pay on fund distributions or the redemption of fund shares. Proposed Item 5(b)(2) of Form N-1A.

understanding of the table. The narrative would be required to be in plain English, but we are not proposing to mandate that specific language be used.⁸² The proposal would require the following information to be included in the narrative disclosure:⁸³

- The differences among the four types of return presented, including whether the returns reflect redemption and the charges and taxes associated with redemption;
- Before-tax returns assume that all distributions are reinvested;
- The assumptions used in calculating after-tax returns, including (i) the use of the historical highest individual federal marginal income tax rates; (ii) the assumption that taxes are paid out of fund distributions and that distributions, less taxes, are reinvested; (iii) the exclusion of state and local taxes; and (iv) if post-liquidation after-tax returns are higher than before-tax returns net of fees and charges payable upon sale of fund shares, the reason for this result, including the assumption that a shareholder has sufficient gains from other sources to offset all losses from the redemption of fund shares;
- Actual after-tax returns depend on an investor's tax situation and may differ from those shown;
- The after-tax returns shown are not relevant to investors who hold their fund shares through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts; and
- After-tax returns reflect past tax effects and are not predictive of future tax effects.

Comment is requested on the proposed narrative disclosure. Should any of the proposed items be eliminated? Should any other items be added? Should the narrative disclosure be specifically required to precede or follow the performance table? Should it appear in another location? Should funds have the flexibility to craft their own narrative disclosure, as proposed, or should the Commission require specific language for part or all of the explanation?

We are not proposing to require that specific items of narrative disclosure be

⁸² See rule 421(b) and (d) under the Securities Act [17 CFR 230.421(b) and (d)](requiring that all information in the prospectus be presented in clear, concise, and understandable fashion and that registrants use plain English principles in the organization, language, and design of the summary and risk factors sections of their prospectuses); General Instruction C.1 to Form N-1A (fund prospectus should be easy to understand and promote effective communication); Item 2 of Form N-1A (requiring that the response to Item 2 be stated in plain English).

⁸³ Proposed Items 2(c)(2)(iv) and 5(b)(3) of Form N-1A.

included in fund advertisements and other sales materials that present after-tax performance. Should we require any narrative disclosure in advertisements and sales literature and, if so, what should it be?

H. Alternatives to Disclosure of After-Tax Return

We considered other possible methods for improving the disclosure of the tax consequences of mutual fund investments, including tax-efficiency ratios and potential capital gains exposure.

Tax-Efficiency Ratios. A tax-efficiency ratio is a ratio of after-tax and before-tax returns that measures the proportion of before-tax return that remains after taxes.⁸⁴ We are not proposing to require funds to disclose tax-efficiency ratios because we believe that these ratios may be more difficult for investors to interpret than after-tax returns. In any event, tax-efficiency ratios may be readily derived from before- and after-tax returns by taking the quotient of these two numbers.

Potential Capital Gains Exposure. When the securities in a mutual fund portfolio appreciate in value, the tax liability is deferred until the securities are sold by the fund and the gains are distributed. An investor who invests in a mutual fund with large amounts of unrealized capital gain, or capital gains that have been realized but not distributed, can potentially have significantly greater tax liability in the future than an investor in a similar fund that has less unrealized or undistributed gain. We considered requiring funds to include in their prospectuses a measure of capital gains exposure that shows the percentage of a fund's assets that represents unrealized and realized but undistributed capital gains.⁸⁵ While we believe that this measure could provide useful information, it would not provide information about the historical tax consequences of a fund's distributions. We believe that pre- and post-liquidation after-tax returns, taken together, would provide a more complete picture.

We request comment on these and other measures that could provide investors with enhanced information about the tax consequences of mutual fund investments. Are any measures

⁸⁴ See Morningstar, MUTUAL FUND 500 (1999 ed.) (reporting mutual fund tax-efficiency ratios); *The Ultimate Mutual Fund Guide 2000*, MONEY, Feb. 2000, at 64 (reporting mutual fund tax-efficiency).

⁸⁵ Both Morningstar, Inc., and *Business Week* publish measures of capital gains exposure. Morningstar, MUTUAL FUND 500 (1999 ed.); *Mutual Fund Scoreboard*, BUSINESS WEEK, Feb. 1, 1999.

preferable to after-tax returns? We also request comment on whether, and how, narrative disclosure in this area should be improved. For example, should the prospectus be required to describe the potential tax consequences to an investor of purchasing fund shares shortly before a dividend declaration date (i.e., "buying the dividend") or purchasing shares in a fund that has significant amounts of unrealized gain in its portfolio securities?⁸⁶ Should shareholder reports be required to describe the tax management strategies the fund used in the most recent period?

I. Technical and Conforming Amendments

We are proposing to amend Rule 482(e)(3) under the Securities Act in order to clarify that the average annual total returns that are required to be shown in any performance advertisement are before-tax returns net of fees and charges payable upon a sale of fund shares.⁸⁷ This clarification is necessary because we have added other types of return to Form N-1A.

We also are proposing to amend rule 34b-1(b)(3) under the Investment Company Act, which excludes performance information contained in periodic reports to shareholders from the updating requirements of rule 34b-1. The proposed amendment extends the exclusion to standardized after-tax return information contained in periodic reports to shareholders.⁸⁸

We also are proposing to delete an instruction contained in Form N-1A that provides that total return information in a mutual fund prospectus need only be current to the end of the fund's most recent fiscal year.⁸⁹ The instruction is unnecessary because the items of Form N-1A that require funds to include total returns in the prospectus have explicit instructions about how current the total return information must be.⁹⁰

J. Compliance Date

If we adopt the proposed disclosure requirements, we expect to require all

⁸⁶ When a fund makes a distribution to its shareholders, the net asset value of the shares declines by the amount of the distribution. Thus, a person who makes a taxable investment in a mutual fund shortly before a distribution may have part of his or her initial investment returned in the form of a taxable distribution.

⁸⁷ 17 CFR 230.482(e)(3).

⁸⁸ 17 CFR 270.34b-1(b)(3)(iii)(B).

⁸⁹ Instruction 6 to Item 21(b)(1) of Form N-1A.

⁹⁰ Item 2(c)(2)(iii) of Form N-1A (providing that total returns included in the risk/return summary must be current to the end of the most recently completed calendar year); Item 5(b)(2) of Form N-1A (providing that total return in the MDFP must be as of the end of the last day of the most recent fiscal year).

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 requests comment on this proposed compliance date.

III. General Request For Comments

The Commission requests comment on the amendments proposed in this Release, suggestions for additional provisions or changes to existing rules or forms, and comments on other matters that might have an effect on the proposals contained in this Release. We also request comment on whether the proposals, if adopted, would promote efficiency, competition, and capital formation. We will consider those comments in satisfying our responsibilities under section 2(c) of the Investment Company Act, section 2(b) of the Securities Act, and section 3(f) of the Exchange Act.⁹¹ For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,⁹² the Commission also requests information regarding the potential effect of the proposals on the U.S. economy on an annual basis. Commenters are requested to provide empirical data to support their views.

IV. Cost/Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules.

The proposed rule and form changes would require a fund to disclose its standardized after-tax returns for 1-, 5-, and 10-year periods. After-tax returns would accompany before-tax returns in the risk/return summary of fund prospectuses and in the MDFP, which is typically contained in fund annual reports. Funds would be required to include a short, explanatory narrative adjacent to the performance table in the risk/return summary and the MDFP. After-tax returns would be presented in two ways:

(i) assuming the shareholder continued to hold his or her shares at the end of the period; and (ii) assuming the shareholder sold his or her shares at the end of the period, realizing taxable gain or loss on the sale. The before- and after-tax returns would be required to be

presented in a standardized tabular format. Although after-tax returns would not be required in fund advertisements and sales literature, any fund choosing to include after-tax returns in these materials would be required to include after-tax returns computed according to our standardized formula.

A. Benefits

Taxes are one of the most significant costs of investing in mutual funds through taxable accounts. Currently, the Commission requires mutual funds to disclose significant information about taxes to investors.⁹³ While this disclosure is useful, we believe funds can more effectively communicate to investors the tax consequences of investing. Therefore, the Commission is proposing amendments to Form N-1A and rules 482 and 34b-1 that would require disclosure of standardized mutual fund after-tax returns.

By requiring all funds to report after-tax performance pursuant to a standardized formula, the proposed amendments would allow investors to compare after-tax performance among funds. This could affect investor decisions relating to the purchase or sale of fund shares. This could have secondary benefits, such as the creation of new funds designed to maximize after-tax performance or causing existing funds to alter their investment strategies to invest in a more tax-efficient manner.

Requiring standardized after-tax performance in the prospectus, annual report, and fund advertisements and sales literature also should help prevent confusing and misleading after-tax performance claims by funds. Currently, fund advertisements and sales literature may contain tax-adjusted performance calculated according to non-standardized methods. In addition to making it difficult to compare after-tax performance measures among different funds, the lack of a standardized method for computing after-tax returns

⁹³ In its prospectus, a mutual fund is required to disclose (i) the tax consequences of buying, holding, exchanging, and selling fund shares, including the tax consequences of fund distributions; and (ii) whether the fund may engage in active and frequent portfolio trading to achieve its principal investment strategies, and, if so, the tax consequences of increased portfolio turnover and how this may affect fund performance. See Item 7(e) of Form N-1A; Instruction 7 to Item 4 of Form N-1A. A fund also must disclose in its prospectus and annual report the portfolio turnover rate and dividends and capital gains distributions per share for each of the last five fiscal years. See Items 9(a) and 22(b)(2) of Form N-1A. These items also require funds to show net realized and unrealized gain or loss on investments on a per share basis for each of the fund's last five fiscal years.

creates the possibility that after-tax performance information as currently reported could be misleading or confusing to investors.

The proposed amendments should also increase the amount of after-tax performance information available to investors. With the exception of the few funds that publish after-tax performance information, investors currently must rely on third party providers to obtain information regarding a fund's after-tax performance.

Moreover, by providing investors with information regarding a fund's after-tax performance, our proposal will help investors understand the magnitude of tax costs and how they affect fund performance. Increased understanding should have the beneficial effect of enhancing investor confidence in the fund industry.

B. Costs

Funds affected by the proposed after-tax requirements will incur costs in complying with the new disclosure. Funds would have to compute the after-tax returns using a standardized method prescribed by Form N-1A. The costs associated with computing the proposed after-tax performance would include the costs of purchasing or developing software, implementing a new system for computing the proposed returns, analyzing data for inclusion in the standardized formula, and training fund employees. In addition, funds would incur costs in incorporating the new disclosure in their prospectuses, annual reports to shareholders, advertisements, and sales literature. Funds could also incur costs in responding to questions from investors regarding the proposed after-tax returns.

It is anticipated that the costs of implementing new systems to compute the standardized after-tax performance will largely consist of one-time expenses. In addition, the software development and implementation costs may be reduced if software vendors begin to offer "off-the-shelf" programs for computing the proposed standardized after-tax performance data.⁹⁴ Also, the costs of analyzing data for inclusion in the standardized formula would be substantially greater in connection with a fund's first-time compliance with the proposed amendments than it would be in subsequent disclosures. Likewise, the

⁹⁴ A service provider that compiles and disseminates fund pricing and performance information recently announced that it will offer to calculate and publish after-tax returns for its fund clients. See Daly, *Program Lets Fund Companies Offer After-Tax Returns* (Dec. 29, 1999) (visited Feb. 9, 2000) <<http://www.ignites.com/>>.

⁹¹ Section 2(c) of the Investment Company Act [15 U.S.C. 80a-2(c)], section 2(b) of the Securities Act [15 U.S.C. 77b(b)], and section 3(f) of the Exchange Act [15 U.S.C. 78c(f)] require the Commission, when determining whether a rule is consistent with the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

⁹² Pub. L. No. 104-21, Title II, 110 Stat. 857 (1996).

costs of revising fund prospectuses, annual reports, advertisements, and sales literature to incorporate the new disclosure should decrease after the first disclosures complying with the proposed amendments have been made. Although the costs of updating the proposed disclosure in fund prospectuses, annual reports, advertisements, and sales literature would be ongoing, the costs incurred in subsequent disclosures should be less than the costs associated with the initial computations and disclosures because neither the formula for calculating performance nor the format for the disclosure is expected to change from year to year.

Because funds filing initial registration statements would not have any performance information to report, the proposed after-tax performance requirements would not impose any additional costs on the preparation and filing of an initial registration statement on Form N-1A. The disclosure required by the proposed amendments would appear in the first post-effective amendment that is required to include the after-tax return disclosure. The costs associated with including the proposed disclosure in this first post-effective amendment would consist of the costs required for developing a system for performing the standardized calculations and the costs of revising the prospectus to incorporate the new disclosure. Because the standardized after-tax disclosure that would be required in a fund's annual report would be very similar to the proposed standardized after-tax disclosure in the prospectus, the cost of including the proposed disclosure in the annual report would largely be limited to the cost of revising the report to incorporate the new disclosure. Moreover, because the proposals require that performance be presented in a standardized tabular format in the prospectus and annual report, the cost of revising these documents should be reduced. The costs incurred by funds choosing to include after-tax returns in fund advertisements and sales literature would be limited to the cost of revising the advertisements and sales literature to incorporate the same proposed standardized after-tax returns that would be required to appear in fund prospectuses.

As discussed above, the proposed amendments could result in the creation of new funds designed to maximize after-tax performance. The proposed amendments could also cause existing funds to alter their investment strategies to invest in a more tax-efficient manner. It is possible that funds could incur

costs as a result of these potential consequences.

To assist in the evaluation of the costs and benefits that may result from these proposed rule amendments, the Commission requests that commenters provide views and data relating to any costs and benefits associated with these proposals.

V. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis ("Analysis") in accordance with 5 U.S.C. 603. The Analysis relates to the proposed amendments to Form N-1A and rules 482 and 34b-1. The following summarizes the Analysis.

The Analysis sets forth the statutory authority for the proposed amendments. The Analysis explains that the proposed form and rule changes would require a fund to disclose its standardized after-tax returns for 1-, 5-, and 10-year periods. The proposal would require after-tax return information to be included in the risk/return summary of the prospectus and in Management's Discussion of Fund Performance ("MDFP"), which is typically contained in the annual report. Funds would be required to include a short, explanatory narrative adjacent to the performance table in the risk/return summary and the MDFP. After-tax returns, which would accompany before-tax returns in fund prospectuses and annual reports, would be presented in two ways: (i) assuming the shareholder continued to hold his or her shares at the end of the period; and (ii) assuming the shareholder sold his or her shares at the end of the period, realizing taxable gain or loss on the sale. The proposed after-tax returns would be required to be presented in a standardized tabular format. Although after-tax returns would not be required in fund advertisements and sales literature, any fund choosing to include after-tax returns in these materials would be required to include after-tax returns computed according to our standardized formula.

The Analysis discusses the impact of the proposed amendments on small entities. For purposes of the Regulatory Flexibility Act, a fund is considered a small entity if the fund, together with other funds in the same group of related funds, has net assets of \$50 million or less as of the end of its most recent fiscal year.⁹⁵

The Analysis notes that as of December 1999, there were approximately 2,900 open-end management investment companies that

may be affected by one or more of the proposed amendments, including 150 that are small entities.

The Analysis also discusses the reporting and other compliance requirements associated with the proposals contained in this Release. The proposed amendments to Form N-1A would require funds subject to the amendments to disclose standardized after-tax returns in prospectuses and annual reports to shareholders. The proposed amendments to rules 482 and 34b-1 would require funds to include standardized after-tax returns in fund advertisements and sales literature when funds voluntarily choose to include after-tax performance information in their advertisements and sales literature.

As explained in the Analysis, after assessing the proposed amendments in light of the current reporting requirements and consulting with industry representatives, we evaluated the effect that the proposed amendments would have on the preparation of registration statements, annual reports to shareholders, advertisements, and sales literature. We estimate that it will take approximately 18 additional hours per portfolio to prepare post-effective amendments to the registration statement on Form N-1A.⁹⁶ The Commission estimates that it will take approximately 7.5 additional hours per management investment company registered on Form N-1A to prepare annual reports to shareholders pursuant to rule 30d-1 if the investment company elects to include the MDFP in the annual report.⁹⁷ The Commission estimates that the proposed amendments to rule 482 will impose approximately .5 additional hours per portfolio on those funds that elect to include after-tax performance information in their advertisements and are therefore required to comply with the proposed amendments to rule 482.⁹⁸

⁹⁶ Since an investment company filing an initial registration statement on Form N-1A has no performance history to disclose, the proposed amendments would not affect such initial filings. This estimate is based upon staff assessment of the proposed amendments in light of the current hour burden and current reporting requirements.

⁹⁷ Form N-1A requires that the prospectus include the MDFP unless the information is included in the fund's latest annual report to shareholders and the fund provides a copy of the annual report, upon request and without charge, to each person to whom a prospectus is delivered. This estimate is based upon staff assessment of the proposed amendments in light of the current hour burden and current reporting requirements.

⁹⁸ As discussed more fully in Section VI, *infra*, the hour burden associated with rule 482 is included in Form N-1A. This estimate is based upon staff assessment of the proposed amendments

⁹⁵ 17 C.F.R. 270.0-10.

We also estimate that an additional .5 hours per response will be imposed by the proposed amendments to rule 34b-1 on those funds that choose to include after-tax performance information in their sales literature.⁹⁹

As stated in the Analysis, the Commission considered several alternatives to the proposed amendments, including establishing different compliance or reporting requirements for small entities or exempting them from all or part of the proposed amendments. The Commission believes that establishing different requirements applicable specifically to small entities is inconsistent with the protection of investors. We note that mutual funds that qualify as small entities are already required to disclose standardized performance. The Commission also believes that adjusting the proposals to establish different compliance requirements for small entities could undercut the purpose of the proposed amendments: to emphasize to investors the impact of taxes on a fund's return and to enable investors to make effective comparisons among various fund performance claims.

The Commission encourages the submission of written comments on matters discussed in the Analysis. Comment specifically is requested on the number of small entities that would be affected by the proposed amendments and the impact of such proposals on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be placed in the same public comment file as comments on the proposals. A copy of the Analysis may be obtained by contacting Maura S. McNulty, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549-0506.

VI. Paperwork Reduction Act

Certain provisions of the proposed amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 [44 U.S.C. 3501, *et seq.*], and the Commission has submitted the proposed collections of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles for the collections of information are: (1) "Form N-1A under the Investment Company Act of 1940

in light of the current hour burden and current reporting requirements.

⁹⁹ This estimate is based upon staff assessment of the proposed amendments in light of the current hour burden and current reporting requirements.

and Securities Act of 1933, Registration Statement of Open-End Management Investment Companies;" (2) "Rule 30d-1 under the Investment Company Act of 1940, Reports to Stockholders of Management Companies;" (3) "Registration Statements—Regulation C;"¹⁰⁰ and (4) "Rule 34b-1 of the Investment Company Act of 1940, Sales Literature Deemed to Be Misleading." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

Form N-1A (OMB Control No. 3235-0307) was adopted pursuant to section 8(a) of the Investment Company Act [15 U.S.C. 80a-8] and section 5 of the Securities Act [15 U.S.C. 77e]. Rule 30d-1 (OMB Control No. 3235-0025) was adopted pursuant to Section 30(e) of the Investment Company Act [15 U.S.C. 80a-29]. Rule 482 of Regulation C (OMB Control No. 3235-0074) was adopted pursuant to section 10(b) of the Securities Act [15 U.S.C. 77j(b)]. Rule 34b-1 (OMB Control No. 3235-0346) was adopted pursuant to section 34(b) of the Investment Company Act [15 U.S.C. 80a-33(b)].

Because taxes are one of the largest costs associated with a mutual fund investment, the Commission is proposing form and rule amendments to Form N-1A, rule 482, and rule 34b-1 to help investors understand the magnitude of tax costs and how they affect fund performance.

Our proposals would require a fund to disclose its standardized after-tax returns for 1-, 5-, and 10-year periods. The proposal would require after-tax return information to be included in the risk/return summary of the prospectus and in Management's Discussion of Fund Performance ("MDFP"), which is typically contained in the annual report. Funds would be required to include a short, explanatory narrative adjacent to the performance table in the risk/return summary and the MDFP. After-tax returns, which would accompany before-tax returns in fund prospectuses and annual reports, would be presented in two ways: (i) Assuming the

¹⁰⁰ The proposed amendments would modify rule 482, which is part of Regulation C under the Securities Act of 1933. Regulation C describes the disclosure that must appear in registration statements under the Securities Act and Investment Company Act. The PRA burden associated with rule 482, however, is included in the investment company registration statement form, not in Regulation C. In this case, the proposed amendments to rule 482 will affect the burden hours for Form N-1A, the registration form for open-end investment companies that currently advertise pursuant to rule 482. We estimate that the burden associated with Regulation C will not change with the amendments to rule 482.

shareholder continued to hold his or her shares at the end of the period; and (ii) assuming the shareholder sold his or her shares at the end of the period, realizing taxable gain or loss on the sale. The before- and after-tax returns would be required to be presented in a standardized tabular format. Although after-tax returns would not be required in fund advertisements and sales literature, the Commission is also proposing amendments to rules 482 and 34b-1 that would require any fund choosing to include after-tax returns in these materials to include after-tax returns computed according to our standardized formula.

The information required by the proposed amendments is primarily for the use and benefit of investors. The Commission is concerned that mutual fund investors who are subject to current taxation may not fully appreciate the impact of taxes on their fund investments because mutual funds are currently required to report their performance on a before-tax basis only. Many investors consider performance one of the most significant factors when selecting or evaluating a fund, and we believe that requiring funds to disclose their after-tax performance would allow investors to make better-informed decisions. The information required to be filed with the Commission pursuant to the information collections also permits the verification of compliance with securities law requirements and assures the public availability and dissemination of the information.

Form N-1A

Form N-1A, including the proposed amendments, contains collection of information requirements. The purpose of Form N-1A is to meet the registration and disclosure requirements of the Securities Act and the Investment Company Act and to enable funds to provide investors with information necessary to evaluate an investment in the fund. The likely respondents to this information collection are open-end funds registering with the Commission on Form N-1A.

We estimate that 170 initial registration statements are filed annually on Form N-1A, registering 298 portfolios, and that the current hour burden per portfolio per filing is 824 hours, for a total annual hour burden of 245,552 hours.¹⁰¹ We estimate that 4,500 post-effective amendments to registration statements are filed

¹⁰¹ These estimates are based on filings received in calendar year 1999. The currently approved hour burden per portfolio for an initial Form N-1A is 824 hours.

annually on Form N-1A, for 7,875 portfolios, and that the current hour burden per portfolio per post-effective amendment filing is 104 hours, for an annual burden of 819,000 hours.¹⁰² Thus, we estimate a current total annual hour burden of 1,064,552 hours for the preparation and filing of Form N-1A and post-effective amendments on Form N-1A.

The proposed amendments would not affect the hour burden of an initial filing of a registration statement on Form N-1A since an investment company filing such an initial form would have no performance history to disclose. Post-effective amendments to such registration statements, however, would contain performance figures and thus be affected by the proposed amendments. We estimate that the proposed amendments would increase the hour burden per portfolio per filing of a post-effective amendment by 18 hours.¹⁰³ Of the 7,875 funds referenced in post-effective amendments, 1,040 are money market funds, which would be exempted from the proposed after-tax disclosure requirements. An additional 1,575 funds are used as investment vehicles for variable insurance contracts, which would be permitted to omit the after-tax information. Thus, approximately 5,260 of the 7,875 funds referenced in post-effective amendments would be affected by the proposed amendments.¹⁰⁴ The Commission estimates that if the proposed amendments to Form N-1A are adopted, the total annual hour burden for all funds for preparation and filing of initial registration statements and post-effective amendments on Form N-1A would be 1,159,311 hours.¹⁰⁵

¹⁰² These estimates are based on filings received in calendar year 1999. The currently approved hour burden per portfolio for post-effective amendments to Form N-1A is 104 hours.

¹⁰³ This estimate is based on the staff's consultations with industry representatives.

¹⁰⁴ The number of funds referenced in post-effective amendments that would be affected by the proposed amendments is computed by subtracting those funds that are exempt from or permitted to omit the proposed after-tax disclosure from the number of funds referenced in post-effective amendments (7,875 - 1,040 - 1,575, or 5,260). For purposes of our analysis, we have not excluded certain funds that also would be permitted to omit the after-tax return disclosure, such as funds that distribute prospectuses for use by investors in 401(k) plans or other similar tax-deferred arrangements. While these funds would be permitted to omit the after-tax return disclosure in prospectuses distributed to investors in these tax-deferred arrangements, they would still incur a burden from including the disclosure in prospectuses distributed to all other investors.

¹⁰⁵ This total annual hour burden is calculated by adding the total annual hour burden for initial registration statements and the total annual hour burden for post-effective amendments, including the additional burden imposed by the proposed

Compliance with the disclosure requirements of Form N-1A is mandatory. Responses to the disclosure requirements will not be kept confidential.

Rule 30d-1 Shareholder Reports

Rule 30d-1, including the proposed amendments, contains collection of information requirements.¹⁰⁶ Section 30(e) and rule 30d-1 require registered management investment companies to transmit to shareholders, at least semi-annually, reports containing financial statements and certain other information. The reports are intended to apprise current shareholders of the operational and financial condition of the fund.

There are approximately 3,490 management investment companies subject to rule 30d-1.¹⁰⁷ The Commission estimates that of those 3,490 management investment companies, approximately 2,280 would be subject to the after-tax disclosure requirements.¹⁰⁸ We estimate that the current hour burden for preparing and filing shareholder reports in compliance

amendments. As explained, the hour burden per portfolio for an initial filing would remain at 824 hours, for a total burden of 245,552 hours. The hour burden per portfolio for a post-effective amendment would be 122 hours (104 + 18), with a burden of 104 hours imposed on all 7,875 portfolios (104 × 7,875, or 819,000) and the additional 18 hours affecting 5,260 portfolios (18 × 5,260, or 94,680). Moreover, since the burden associated with rule 482 is included in Form N-1A (as discussed in note 100, *supra*), the Form N-1A burden would include the estimated rule 482 burden of .5 hours (the rule 482 burden is discussed below) that would be imposed on the three percent of funds that we estimate would advertise after-tax returns [.5 × (5,260 × 3%), or 79]. Thus, the total annual hour burden for all funds for the preparation and filing of initial registration statements and post-effective amendments on Form N-1A, including the proposed amendments would be 1,159,311 hours (245,552 + 819,000 + 94,680 + 79).

¹⁰⁶ The proposed amendments to Form N-1A require that if a fund elects to include the MDFP in its annual report, it must include the after-tax return information in its annual report.

¹⁰⁷ These estimates are based on filings received in calendar year 1999. The currently approved hour burden per registered management investment company subject to rule 30d-1 is 202.5 hours.

¹⁰⁸ The Commission estimates that 2,900 of the 3,490 investment companies subject to rule 30d-1 are registered on Form N-1A and therefore would be subject to the proposed amendments. Of these 2,900 investment companies, the Commission estimates that approximately 200 offer only money market funds and would therefore be exempt from the proposed amendments, and that approximately 300 other investment companies would also be exempt because they serve as investment options for variable insurance contracts. Moreover, the Commission estimates that approximately five percent of funds do not elect to locate the MDFP in their annual reports and therefore would not incur any additional burden in including the proposed disclosure in their annual reports. Thus, the number of investment companies that would be subject to the after-tax requirements is 2,280 [(2,900 - 200 - 300) × 95%].

with rule 30d-1 is 202.5 hours. With the proposed amendments, we estimate that the hour burden will be increased by 7.5 hours¹⁰⁹ to 210 hours, for a total annual hour burden to the industry of 723,825.¹¹⁰

Compliance with the disclosure requirements of rule 30d-1 is mandatory. Responses to the disclosure requirements will not be kept confidential.

Rule 482

Rule 482, including the proposed amendments, contains collection of information requirements. The rule is a safe harbor that permits a fund to advertise information the "substance of which" is contained in its statutory prospectus, subject to the requirements of the rule. Rule 482 limits performance information to standardized quotations of yield and total return and other measures of performance that reflect all elements of return.

The increased burden associated with the proposed amendments to rule 482 is included in the investment company registration statement forms.¹¹¹ Thus, the proposed amendments to rule 482 will affect the burden hours for Form N-1A, the registration form for open-end investment companies that currently may advertise pursuant to rule 482. As described above, there are approximately 5,260 funds filing post-effective amendments that would be affected by the proposed amendments. The Commission further estimates that three percent of these funds would elect to advertise after-tax performance and therefore be required to comply with the proposed amendments to rule 482.¹¹² We estimate that the additional hour burden required to comply with the proposed amendments to rule 482 is .5 hours.¹¹³

Compliance with Rule 482 is mandatory for every registered fund that issues advertisements. Responses to the disclosure requirements will not be kept confidential.

Rule 34b-1

Rule 34b-1, including the proposed amendments, contains collection of information requirements. The rule

¹⁰⁹ This estimate is based on the staff's consultations with industry representatives.

¹¹⁰ The total annual hour burden is computed by adding the current total annual burden (3,490 × 202.5, or 706,725) to the total additional annual burden imposed by the proposed amendments (2,280 × 7.5, or 17,100).

¹¹¹ See note 100, *supra*.

¹¹² This estimate is based on the assumption that tax-managed funds and index funds would be most likely to advertise after-tax performance.

¹¹³ This estimate is based on the staff's consultations with industry representatives.

governs sales material that is accompanied or preceded by the delivery of a statutory prospectus and requires the inclusion of standardized performance data and certain legend disclosure in sales material that includes performance data.

We estimate that approximately 8,495 respondents file approximately 4.35 responses annually pursuant to rule 34b-1.¹¹⁴ Of these respondents, we estimate that 1,040 are money market funds that would be exempted from the proposed amendments and that an additional 620 funds and unit investment trusts ("UITs") registered on Forms N-3 and N-4 would not be affected by the proposed amendments. We estimate that an additional 1,575 funds registered on Form N-1A and subject to rule 34b-1 are used as underlying portfolios for variable insurance contracts and would not advertise after-tax performance due to their unique tax-deferred nature. Thus, 5,260 respondents subject to rule 34b-1 would also be subject to the proposed after-tax disclosure.¹¹⁵ We further estimate that three percent of respondents subject to rule 34b-1 would elect to include after-tax performance and therefore be subject to the proposed amendments.¹¹⁶ The burden for rule 34b-1 requires approximately 2.4 hours per response resulting from creating the information required by rule 34b-1. We estimate that rule 34b-1 imposes a current total annual reporting burden of 88,800 hours on the industry.¹¹⁷ We estimate that the additional hour burden required to comply with the proposed amendments to rule 34b-1 is .5 hours, for a total burden per response of 2.9 hours and a total annual burden on the industry of 89,143 hours.¹¹⁸

Compliance with rule 34b-1 is mandatory for every registered

investment company that issues sales literature. Responses to the disclosure requirements will not be kept confidential.

Request for Comments

We request your comments on the accuracy of our estimates. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, New Executive Office Building, Washington, D.C. 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549-0609, with reference to File No. S7-09-00. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release.

VII. Statutory Authority

The Commission is proposing amendments to Form N-1A pursuant to authority set forth in sections 5, 6, 7, 10, and 19(a) of the Securities Act [15 U.S.C. 77e, 77f, 77g, 77j, 77s(a)] and sections 8, 24(a), 30, and 38 of the Investment Company Act [15 U.S.C. 80a-8, 80a-24(a), 80a-29, 80a-37]. The Commission is proposing amendments to rule 482 pursuant to authority set forth in sections 5, 10(b), and 19(a) of the Securities Act [15 U.S.C. 77e, 77j(b), and 77s(a)]. The Commission is proposing amendments to rule 34b-1 pursuant to authority set forth in sections 34(b) and 38(a) of the Investment Company Act [15 U.S.C. 80a-33(b) and 80a-37(a)].

List of Subjects

17 CFR Part 230

Advertising, Investment companies, Reporting and recordkeeping requirements, Securities.

17 CFR Part 239

Reporting and recordkeeping requirements, Securities.

17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Proposed Rules and Forms

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78l, 78m, 78n, 78o, 78w, 78ll(d), 79t, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

2. Section 230.482 is amended by:
- revising the introductory text of paragraph (e)(3);
 - removing “; and” at the end of paragraph (e)(3)(iv) and in its place adding a period;
 - redesignating paragraph (e)(4) as paragraph (e)(5);
 - adding new paragraph (e)(4); and
 - revising newly redesignated paragraph (e)(5) to read as follows:

§ 230.482 Advertising by an investment company as satisfying requirements of section 10.

* * * * *

(e) * * *

(3) Before-tax average annual total return (with redemption) for one, five, and ten year periods; *Provided*, That if the company's registration statement under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) has been in effect for less than one, five, or ten years, the time period during which the registration statement was in effect is substituted for the period(s) otherwise prescribed; and *Provided further*, That such quotations:

* * * * *

(4) For an open-end management investment company, after-tax average annual total return (with and without redemption) for one, five, and ten year periods; *Provided*, That if the company's registration statement under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) has been in effect for less than one,

¹¹⁴ These estimates are based on filings received in calendar year 1999. The currently approved hour burden per response for rule 34b-1 is 2.4 hours.

¹¹⁵ This number is computed by subtracting from the number of respondents filing rule 34b-1 sales material the number of money market funds, the number of funds and UITs registered on Forms N-3 and N-4, and the number of funds used as underlying portfolios for variable insurance contracts (8,495 - 1,040 - 620 - 1,575, or 5,260).

¹¹⁶ This estimate is based on the assumption that tax-managed funds and index funds would be most likely to advertise after-tax performance.

¹¹⁷ The current total annual hour burden is computed by multiplying the number of responses filed annually under rule 34b-1 by the current hour burden (37,000 x 2.4). The total annual hour burden for the industry has increased significantly from previous estimates because we have reevaluated the number of respondents subject to rule 34b-1.

¹¹⁸ The total annual burden is computed by adding the current burden (2.4 x 37,000, or 88,800) to the additional burden imposed by the proposed amendments [5 x (8,495 - 1,040 - 620 - 1,575) x 4.35 x 3%, or 343].

five, or ten years, the time period during which the registration statement was in effect is substituted for the period(s) otherwise prescribed; and *Provided further*, That such quotations:

- (i) Are based on the methods of computation prescribed in Form N-1A;
(ii) Are current to the most recent calendar quarter ended prior to the submission of the advertisement for publication;
(iii) Are accompanied by quotations of total return as provided for in paragraph (e)(3) of this section;
(iv) Include both after-tax average annual total return (with redemption) and after-tax average annual total return (without redemption);
(v) Are set out with equal prominence and are set out in no greater prominence than the required quotations of total return; and
(vi) Identify the length of and the last day of the one, five, and ten year periods; and

(5) Any other historical measure of company performance (not subject to any prescribed method of computation) if such measurement:

- (i) Reflects all elements of return;
(ii) Is accompanied by quotations of total return as provided for in paragraph (e)(3) of this section;
(iii) In the case of any measure of performance adjusted to reflect the effect of taxes, is accompanied by quotations of total return as provided for in paragraph (e)(4) of this section;
(iv) Is set out in no greater prominence than the required quotations of total return; and
(v) Identifies the length of and the last day of the period for which performance is measured.

* * * * *

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

3. The authority citation for part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, 80a-39 unless otherwise noted:

* * * * *

- 4. Section 270.34b-1 is amended by:
a. redesignating paragraphs (b)(1)(iii) (B) and (C) as paragraphs (b)(1)(iii) (C) and (D);
b. adding new paragraph (b)(1)(iii)(B); and
c. revising paragraph (b)(3) to read as follows:

§ 270.34b-1 Sales literature deemed to be misleading.

* * * * *

(b)(1) * * *

(iii) * * *

(B) Accompany any quotation of performance adjusted to reflect the effect of taxes with the quotations of total return specified by paragraph (e)(4) of § 230.482 of this chapter;

* * * * *

(3) The requirements specified in paragraph (b)(1) of this section shall not apply to any quarterly, semi-annual, or annual report to shareholders under Section 30 of the Act (15 U.S.C. 80a-29) containing performance data for a period commencing no earlier than the first day of the period covered by the report; nor shall the requirements of paragraphs (e)(3)(ii), (e)(4)(ii), and (f) of § 230.482 of this chapter apply to any such periodic report containing any other performance data.

* * * * *

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

5. The authority citation for part 239 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 79e, 79f, 79g, 79j, 79l, 79m, 79n, 79q, 79t, 80a-8, 80a-24, 80a-29, 80a-30 and 80a-37, unless otherwise noted.

* * * * *

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

6. The authority citation for part 274 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, and 80a-29, unless otherwise noted.

Note: The text of Form N-1A does not and these amendments will not appear in the Code of Federal Regulations.

7. General Instruction C to Form N-1A (referenced in §§ 239.15A and 274.11A) is amended by:

- a. revising the introductory text of paragraph 3.(d)(i);
b. republishing paragraph 3.(d)(i)(A);
c. republishing paragraph 3.(d)(i)(B) except for removing "and" at the end of the paragraph;
d. republishing paragraph 3.(d)(i)(C) except for removing the period at the end of the paragraph and adding in its place "; and"; and
e. adding paragraph 3.(d)(i)(D) to read as follows:

Form N-1A

* * * * *

General Instructions

* * * * *

C. Preparation of the Registration Statement

* * * * *

3. Additional Matters:

* * * * *

(d) Modified Prospectuses for Certain Funds.

(i) A Fund may omit the information required by Items 2(c)(2)(iii)(A), (B), and (D), 2(c)(2)(iv), 5(b)(2)(i), (ii), and (iv), and 5(b)(3), and a Fund may modify or omit, if inapplicable, the information required by Items 7(b)-(d) and 8(a)(2), if the Fund's prospectus will be used exclusively to offer Fund shares as investment options for:

(A) A defined contribution plan that meets the requirements for qualification under section 401(k) of the Internal Revenue Code (26 U.S.C. 401(k));

(B) A tax-deferred arrangement under sections 403(b) or 457 of the Internal Revenue Code (26 U.S.C. 403(b) and 457);

(C) A variable contract as defined in section 817(d) of the Internal Revenue Code (26 U.S.C. 817(d)), if covered in a separate account prospectus; and

(D) 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.

* * * * *

8. Item 2 of Form N-1A (referenced in §§ 239.15A and 274.11A) is amended by:

- a. revising paragraph (c)(2)(iii);
b. adding paragraph (c)(2)(iv);
c. revising paragraph (a) of Instruction 2; and
d. revising paragraph (c) of Instruction 3 to read as follows:

Form N-1A

* * * * *

Item 2. Risk/Return Summary: Investments, Risks, and Performance

* * * * *

(c) * * *

(2) * * *

(iii) If the Fund has annual returns for at least one calendar year, provide a table showing the Fund's (A) before-tax average annual total return (without redemption); (B) after-tax average annual total return (without redemption); (C) before-tax average annual total return (with redemption); and (D) after-tax average annual total return (with redemption). A Money Market Fund should show only the returns described in clause (C) of the preceding sentence. All returns should be shown for 1-, 5-, and 10-calendar year periods ending on the date of the most recently completed calendar year (or for the life of the Fund, if shorter), but only for periods subsequent to the effective date of the Fund's registration statement. The table also should show

the returns of an appropriate broad-based securities market index as defined in Instruction 5 to Item 5(b) for the same periods. A Fund that has been in existence for more than 10 years also may include average annual total

returns for the life of the Fund. A Money Market Fund may provide the Fund's 7-day yield ending on the date of the most recent calendar year or disclose a toll-free (or collect) telephone number that investors can use to obtain

the Fund's current 7-day yield. For a Fund (other than a Money Market Fund or a Fund described in General Instruction C.3.(d)(i)), provide the information in the following table with the specified captions:

AVERAGE ANNUAL TOTAL RETURNS
[For the periods ended December 31, —]

	1 year	5 years	10 years
If You Continue to Hold Your Shares at End of Period:			
Before-Tax Return	—%	—%	—%
After-Tax Return	—%	—%	—%
If You Sell Your Shares at End of Period:			
Before-Tax Return	—%	—%	—%
After-Tax Return	—%	—%	—%
Index (reflects no deduction for fees, expenses, or taxes)	—%	—%	—%

(iv) Adjacent to the table required by paragraph (c)(2)(iii) of this Item, provide a brief explanation of the following:

(A) The differences among the four types of return presented, including whether the returns reflect redemption and the charges and taxes associated with redemption;

(B) That before-tax returns assume that all distributions are reinvested;

(C) The assumptions used in calculating after-tax returns, including (1) the use of the historical highest individual federal marginal income tax rates; (2) the assumption that taxes are paid out of fund distributions and that distributions, less taxes, are reinvested; (3) the exclusion of state and local taxes; and (4) if after-tax returns (with redemption) are higher than before-tax returns (with redemption), explain the reason for this result, including the assumption that a shareholder has sufficient gains from other sources to offset all losses from the redemption of fund shares;

(D) Actual after-tax returns depend on an investor's tax situation and may differ from those shown;

(E) The after-tax returns shown are not relevant to investors who hold their Fund shares through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts; and

(F) After-tax returns reflect past tax effects and are not predictive of future tax effects.

Instructions

* * * * *

2. Table.

(a) Calculate a Money Market Fund's 7-day yield under Item 21(a); the Fund's before-tax average annual total return (without redemption) and before-tax average annual total return (with redemption) under Items 21(b)(1) and (2), respectively; and the Fund's after-tax average annual total return (without redemption) and after-tax average annual total return (with redemption) under Items 21(b)(3) and (4), respectively.

* * * * *

3. Multiple Class Funds.

* * * * *

(c) Provide average annual total returns in the table for each Class offered in the prospectus. The four types of return for each Class required under Item 2(c)(2)(iii)(A), (B), (C), and (D) should be adjacent and should not be interspersed with the returns of other Classes.

* * * * *

9. Item 5 of Form N-1A (referenced in §§ 239.15A and 274.11A) is amended by:

- a. revising paragraph (b)(2);
- b. adding paragraph (b)(3); and
- c. adding Instruction 12 to read as follows:

AVERAGE ANNUAL TOTAL RETURNS
[For the Fiscal Year ended]

	1 year	5 years	10 years
If You Continue to Hold Your Shares at End of Period:			
Before-Tax Return	—%	—%	—%
After-Tax Return	—%	—%	—%
If You Sell Your Shares at End of Period:			

Form N-1A

* * * * *

Item 5. Management's Discussion of Fund Performance

* * * * *

(b)(1) * * *

(2) Include a statement accompanying the graph to the effect that past performance does not predict future performance and that account value does not reflect the taxes that a shareholder would pay on fund distributions or the redemption of fund shares. In a table placed within or next to the graph, provide the Fund's (i) before-tax average annual total return (without redemption); (ii) after-tax average annual total return (without redemption); (iii) before-tax average annual total return (with redemption); and (iv) after-tax average annual total return (with redemption). All returns should be shown for the 1-, 5-, and 10-year periods as of the end of the last day of the most recent fiscal year (or for the life of the Fund, if shorter), but only for periods subsequent to the effective date of the Fund's registration statement. All returns should be computed in accordance with Items 21(b)(1), (b)(2), (b)(3), and (b)(4). For a Fund other than a Fund described in General Instruction C.3.(d)(i), provide the information in the following table with the specified captions:

AVERAGE ANNUAL TOTAL RETURNS—Continued
[For the Fiscal Year ended]

	1 year	5 years	10 years
Before-Tax Return	___%	___%	___%
After-Tax Return	___%	___%	___%

(3) Adjacent to the table required by paragraph (b)(2) of this Item, provide a brief explanation of the following:

(i) The differences among the four types of return presented, including whether the returns reflect redemption and the charges and taxes associated with redemption;

(ii) That before-tax returns assume that all distributions are reinvested;

(iii) The assumptions used in calculating after-tax returns, including (A) the use of the historical highest individual federal marginal income tax rates; (B) the assumption that taxes are paid out of fund distributions and that distributions, less taxes, are reinvested; (C) the exclusion of state and local taxes; and (D) if after-tax returns (with redemption) are higher than before-tax returns (with redemption), explain the reason for this result, including the assumption that a shareholder has sufficient gains from other sources to offset all losses from the redemption of fund shares;

(iv) Actual after-tax returns depend on an investor's tax situation and may differ from those shown;

(v) The after-tax returns shown are not relevant to investors who hold their Fund shares through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts; and

(vi) After-tax returns reflect past tax effects and are not predictive of future tax effects.

Instructions

* * * * *

12. Table for Multiple Class Funds.

Provide average annual total returns in the table for each Class of a Multiple Class Fund that is offered in the prospectus or covered by the annual report. The four types of return for each Class required under Item 5(b)(2)(i), (ii), (iii), and (iv) should be adjacent and should not be interspersed with the returns of other Classes.

* * * * *

10. Item 21 of Form N-1A (referenced in §§ 239.15A and 274.11A) is amended by:

a. revising the phrase "(b)(1)-(4)" to read "(b)(1)-(7)" in the introductory text of paragraph (b);

b. redesignating paragraphs (b)(1), (2), (3), (4), and (5) as paragraphs (b)(2), (5), (6), (7), and (8), respectively;

c. adding new paragraphs (b)(1), (b)(3), and (b)(4); and

d. revising newly redesignated paragraph (b)(2) to read as follows:

Form N-1A

* * * * *

Item 21. Calculation of Performance Data

* * * * *

(b) * * *

(1) Before-Tax Average Annual Total Return (Without Redemption) Quotation.

For the 1-, 5-, and 10-year periods ended on the date of the most recent balance sheet included in the registration statement (or for the periods the Fund has been in operation), calculate the Fund's before-tax average annual total return (without redemption) by finding the average annual compounded rates of return over the 1-, 5-, and 10-year periods (or for the periods of the Fund's operations) that would equate the initial amount invested to the ending redeemable value, according to the following formula:

$$P(1+T)^n = ERV_{NR}$$

Where:

P = a hypothetical initial payment of \$1,000.

T = before-tax average annual total return (without redemption).

n = number of years.

ERV_{NR} = ending redeemable value of a hypothetical \$1,000 payment made at the beginning of the 1-, 5-, or 10-year periods at the end of the 1-, 5-, or 10-year periods (or fractional portion) assuming no redemption of the account.

Instructions

1. Assume the maximum sales load (or other charges deducted from payments) is deducted from the initial \$1,000 payment.

2. Assume all distributions by the Fund are reinvested at the price stated in the prospectus (including any sales load imposed upon reinvestment of dividends) on the reinvestment dates during the period.

3. Include all recurring fees that are charged to all shareholder accounts. For any account fees that vary with the size of the account, assume an account size

equal to the Fund's mean (or median) account size. Reflect, as appropriate, any recurring fees charged to shareholder accounts that are paid other than by redemption of the Fund's shares.

4. Determine the ending redeemable value by assuming no redemption at the end of the 1-, 5-, or 10-year periods. Deduct any charges that are deducted at the end of each period assuming no redemption. Do not deduct nonrecurring charges deducted only on redemption, such as deferred sales loads or redemption fees.

5. State the before-tax average annual total return (without redemption) quotation to the nearest hundredth of one percent.

(2) Before-Tax Average Annual Total Return (With Redemption) Quotation.

For the 1-, 5-, and 10-year periods ended on the date of the most recent balance sheet included in the registration statement (or for the periods the Fund has been in operation), calculate the Fund's before-tax average annual total return (with redemption) by finding the average annual compounded rates of return over the 1-, 5-, and 10-year periods (or for the periods of the Fund's operations) that would equate the initial amount invested to the ending redeemable value, according to the following formula:

$$P(1+T)^n = ERV_R$$

Where:

P = a hypothetical initial payment of \$1,000.

T = before-tax average annual total return (with redemption).

n = number of years.

ERV_R = ending redeemable value of a hypothetical \$1,000 payment made at the beginning of the 1-, 5-, or 10-year periods at the end of the 1-, 5-, or 10-year periods (or fractional portion), assuming the account is redeemed at the end of the last day of the measurement period.

Instructions

1. Assume the maximum sales load (or other charges deducted from payments) is deducted from the initial \$1,000 payment.

2. Assume all distributions by the Fund are reinvested at the price stated

in the prospectus (including any sales load imposed upon reinvestment of dividends) on the reinvestment dates during the period.

3. Include all recurring fees that are charged to all shareholder accounts. For any account fees that vary with the size of the account, assume an account size equal to the Fund's mean (or median) account size. Reflect, as appropriate, any recurring fees charged to shareholder accounts that are paid other than by redemption of the Fund's shares.

4. Determine the ending redeemable value by assuming a complete redemption at the end of the 1-, 5-, or 10-year periods and the deduction of all nonrecurring charges deducted at the end of each period. If shareholders are assessed a deferred sales load, assume the maximum deferred sales load is deducted at the times, in the amounts, and under the terms disclosed in the prospectus.

5. State the before-tax average annual total return (with redemption) quotation to the nearest hundredth of one percent.

(3) *After-Tax Average Annual Total Return (Without Redemption) Quotation.* For the 1-, 5-, and 10-year periods ended on the date of the most recent balance sheet included in the registration statement (or for the periods the Fund has been in operation), calculate the Fund's after-tax average annual total return (without redemption) by finding the average annual compounded rates of return over the 1-, 5-, and 10-year periods (or for the periods of the Fund's operations) that would equate the initial amount invested to the after-tax ending value, according to the following formula:

$$P(1+T)^n = \text{ATV}_{\text{NR}}$$

Where:

P = a hypothetical initial payment of \$1,000.

T = after-tax average annual total return (without redemption).

n = number of years.

ATV_{NR} = ending after-tax value of a hypothetical \$1,000 payment made at the beginning of the 1-, 5-, or 10-year periods at the end of the 1-, 5-, or 10-year periods (or fractional portion), assuming no redemption of the account.

Instructions

1. Assume the maximum sales load (or other charges deducted from payments) is deducted from the initial \$1,000 payment.

2. Assume all distributions by the Fund, less the taxes due on such distributions, are reinvested at the price stated in the prospectus (including any sales load imposed upon reinvestment

of dividends) on the reinvestment dates during the period.

3. Calculate the taxes due on any distributions by the Fund by applying the tax rate specified in Instruction 4 to each component of the distributions on the reinvestment date (e.g., ordinary income, short-term capital gain, long-term capital gain). The taxable amount and tax character of each distribution should be as specified by the Fund on the dividend declaration date, but may be adjusted to reflect subsequent recharacterizations of distributions. Distributions should be adjusted to reflect the federal tax impact the distribution would have on an individual taxpayer on the reinvestment date. For example, assume no taxes are due on the portions of any distribution that would not result in federal income tax on an individual, e.g., tax-exempt interest or non-taxable returns of capital.

4. Calculate the taxes due using the highest individual marginal federal income tax rate in effect on the reinvestment date. The rate used should correspond to the tax character of each component of the distributions (e.g., ordinary income rates for ordinary income distributions, short-term capital gain rates for short-term capital gain distributions, long-term capital gain rates for long-term capital gain distributions). Note that the required tax rates may vary over the measurement period. Disregard any potential tax liabilities other than federal tax liabilities (e.g., state and local taxes); the effect of phaseouts of certain exemptions, deductions, and credits at various income levels; and the impact of the federal alternative minimum tax.

5. Include all recurring fees that are charged to all shareholder accounts. For any account fees that vary with the size of the account, assume an account size equal to the Fund's mean (or median) account size. Assume that no additional taxes or tax credits result from any redemption of shares required to pay such fees. Reflect, as appropriate, any recurring fees charged to shareholder accounts that are paid other than by redemption of the Fund's shares.

6. Determine the ending after-tax value by assuming no redemption at the end of the 1-, 5-, or 10-year periods. Deduct any charges that are deducted at the end of each period assuming no redemption. Do not deduct nonrecurring charges deducted only on redemption, such as deferred sales loads or redemption fees.

7. State the after-tax average annual total return (without redemption) quotation to the nearest hundredth of one percent.

(4) *After-Tax Average Annual Total Return (With Redemption) Quotation.* For the 1-, 5-, and 10-year periods ended on the date of the most recent balance sheet included in the registration statement (or for the periods the Fund has been in operation), calculate the Fund's after-tax average annual total return (with redemption) by finding the average annual compounded rates of return over the 1-, 5-, and 10-year periods (or for the periods of the Fund's operations) that would equate the initial amount invested to the after-tax ending value, according to the following formula:

$$P(1 + T)^n = \text{ATV}_R$$

Where:

P = a hypothetical initial payment of \$1,000.

T = after-tax average annual total return (with redemption).

n = number of years.

ATV_R = ending after-tax value of a hypothetical \$1,000 payment made at the beginning of the 1-, 5-, or 10-year periods at the end of the 1-, 5-, or 10-year periods (or fractional portion), assuming the account is redeemed at the end of the last day of the measurement period.

Instructions

1. Assume the maximum sales load (or other charges deducted from payments) is deducted from the initial \$1,000 payment.

2. Assume all distributions by the Fund, less the taxes due on such distributions, are reinvested at the price stated in the prospectus (including any sales load imposed upon reinvestment of dividends) on the reinvestment dates during the period.

3. Calculate the taxes due on any distributions by the Fund by applying the tax rate specified in Instruction 4 to each component of the distributions on the reinvestment date (e.g., ordinary income, short-term capital gain, long-term capital gain). The taxable amount and tax character of each distribution should be as specified by the Fund on the dividend declaration date, but may be adjusted to reflect subsequent recharacterizations of distributions. Distributions should be adjusted to reflect the federal tax impact the distribution would have on an individual taxpayer on the reinvestment date. For example, assume no taxes are due on the portions of any distributions that would not result in federal income tax on an individual, e.g., tax-exempt interest or non-taxable returns of capital.

4. Calculate the taxes due using the highest individual marginal federal

income tax rate in effect on the reinvestment date. The rate used should correspond to the tax character of each component of the distributions (*e.g.*, ordinary income rates for ordinary income distributions, short-term capital gain rates for short-term capital gain distributions, long-term capital gain rates for long-term capital gain distributions). Note that the required tax rates may vary over the measurement period. Disregard any potential tax liabilities other than federal tax liabilities (*e.g.*, state and local taxes); the effect of phaseouts of certain exemptions, deductions, and credits at various income levels; and the impact of the federal alternative minimum tax.

5. Include all recurring fees that are charged to all shareholder accounts. For any account fees that vary with the size of the account, assume an account size equal to the Fund's mean (or median) account size. Assume that no additional taxes or tax credits result from any redemption of shares required to pay such fees. Reflect, as appropriate, any recurring fees charged to shareholder accounts that are paid other than by redemption of the Fund's shares.

6. Determine the ending after-tax value by assuming a complete

redemption at the end of the 1-, 5-, or 10-year periods and the deduction of all nonrecurring charges deducted at the end of each period. If shareholders are assessed a deferred sales load, assume the maximum deferred sales load is deducted at the times, in the amounts, and under the terms disclosed in the prospectus.

7. Determine ending after-tax value by subtracting capital gains taxes resulting from the redemption and adding the tax benefit from capital losses resulting from the redemption.

(a) Calculate the capital gain or loss upon redemption by subtracting the tax basis from the redemption proceeds (after deducting any nonrecurring charges as specified by Instruction 6).

(b) In determining the tax basis, include the initial \$1,000 payment and reinvested distributions (net of taxes assumed paid from the distributions, but not net of any sales loads imposed upon reinvestment). Also, adjust the tax basis for any distributions representing returns of capital and any other tax basis adjustments that would apply to an individual taxpayer.

(c) When determining the character of capital gain or loss upon redemption, the Fund should track the actual

holding periods of reinvested distributions. That is, the Fund should not assume that shares acquired through reinvestment of distributions have the same holding period as the initial \$1,000 investment.

(d) Calculate the capital gains taxes (or the benefit resulting from tax losses) by multiplying the amount of the capital gain (loss) by the highest federal individual capital gains tax rate in effect on the redemption date. The rate used should correspond to the tax character of the capital gains (*e.g.*, short-term or long-term), which is determined by the length of the measurement period in the case of the initial \$1,000 investment and the length of the period between reinvestment and the end of the measurement period in the case of reinvested distributions.

8. State the after-tax average annual total return quotation (with redemption) to the nearest hundredth of one percent.

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By the Commission.
Dated: March 15, 2000.

Margaret H. McFarland,

Deputy Secretary.

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