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MERCATUS CENTER

REGULATORY STUDIES PROGRAM

Public Interest Comment on
The Securities and Exchange Commission's Request for Comment on

DISCLOSURE OF MUTUAL FUND AFTER-TAX RETURNS[1]

The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP employs contemporary economic scholarship to assess rulemaking proposals from the perspective of the public interest. Thus, our comments on the Securities and Exchange Commission's proposal requiring disclosure of mutual fund after-tax returns do not represent the views of any particular affected party or special interest group, but are designed to evaluate the effect of the Commission's proposals on overall consumer welfare.

The Securities and Exchange Commission (SEC) is concerned that investors are not receiving the information they need regarding the tax consequences of investing in mutual funds. The simple solution to this problem, in the SEC's view, is to require mutual funds to report standardized after-tax returns along with the standardized pre-tax returns they already report. The SEC's proposal, however, is inferior to the current market response and is unlikely to generate net benefits to investors.

As described in the proposal, the private sector has begun to provide to investors the information and tools they may need to understand the tax consequences of mutual fund investments. Those investors who wish to do so may learn more today about their own tax consequences from these resources than they will be able to learn from the SEC's proposed solution. The SEC's one-size-fits-all approach is not only unnecessary, but will impose costs on investors with no corresponding benefit.

I. Background

It is clear that taxes take a huge bite out of returns to mutual fund investors. The SEC release states that an estimated 15 percent of the annual gains on diversified U.S stock funds was turned over to the taxing authorities during the last five years.[2] It is also true that the tax structure is complex, and the size of the tax bite varies from fund to fund.

[1] Prepared by Jeffry L. Davis, Senior Economist, Economists Incorporated, Washington, DC. This comment is one in a series of public interest comments from the Mercatus Center's Regulatory Studies Program, and does not reflect an official position of George Mason University.
[2] *Request for Comment*, pp. 2-3. All references to page numbers refer to pagination that results when the html version of the document is printed out on paper.

Taxes are assessed on income and capital gains distributions made by a fund, and the amounts of these distributions vary from one fund to another.

The SEC requires mutual funds to disclose a great deal of information in their prospectuses, their annual reports, and in their advertisements and sales literature. The SEC views its proposal to require the disclosure of after-tax returns as "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."[3]

This latest SEC action would require mutual funds to disclose after-tax return information in the risk/return summary of the prospectus and in Management's Discussion of Fund Performance, which is usually contained in the annual report. The proposal would not require funds 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. 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. Post-liquidation after-tax return assumes that the investor sells his fund shares at the end of the measurement period.

II. The SEC's Analysis and Economic Theory

The SEC states that "many investors lack a clear understanding of the impact of taxes on their mutual fund investments."[4] This is no doubt true. Taxes are complicated and investments are complicated. Many investors will still lack a clear understanding of the impact of taxes on their mutual fund investments after the SEC imposes this new requirement, assuming it proceeds as planned. Investors who do not understand how mutual fund returns are taxed will not understand what the SEC's standardized after-tax returns mean.

The amount of tax assessed on a mutual fund investment is not necessarily related to the size of the pre-tax return on that investment. Two nearly identical funds can generate very different after-tax returns in a given year, simply because one of the funds realizes a gain on some of its holdings while the other does not. Also, as the release points out, an investor can be hit with a tax bill in a given year even though the fund generated a loss for the year. An investor who does not understand how this can happen will be just as confused when he sees the standardized after-tax returns the SEC proposes to require of mutual funds. An investor who already understands how mutual fund returns are taxed will understand the standardized after-tax returns, but he would not need the SEC requirement to obtain information on after-tax returns. More importantly, the private sector is responding to both types of investors.

[3] *Request for Comment*, p. 3.
[4] *Request for Comment*, p. 3.

The SEC interprets the private sector initiatives as evidence that the SEC should mandate such disclosure, when the opposite is true. The private sector initiatives demonstrate that there is no market failure to be cured through regulation. While it appears that there is some demand by investors for information on after-tax returns, the industry and others have responded to that demand.

III. What is the Problem?

The SEC release acknowledges, "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."[5] Vanguard, for example, has on its website an after-tax returns calculator that allows a visitor to select a Vanguard fund, specify a federal marginal tax rate, a state and local tax rate, and a starting and ending period.[6] The calculator produces a pre-tax return and two after-tax returns, one that assumes the investment continues to be held at the end of the period and one that assumes it is sold at the end of the period. Fidelity's website calculator (provided by Morningstar) is less flexible than Vanguard's in that it does not allow the visitor to alter tax rates or holding periods, but it covers more than 4,000 funds.[7] Charles Schwab's detailed performance information, available for over 1,000 funds, includes after-tax returns.[8] Eaton Vance provides after-tax returns for its four tax-managed equity funds.[9] Morningstar reports after-tax returns that are available to registered members.[10] Personal Fund, Inc. also provides after-tax returns for virtually any fund based on user-specified tax rates, and it identifies other funds that compare favorably to the selected fund.[11]

In short, there are numerous sources of information and tools available to investors without any need for any SEC requirement. Not only do mutual funds themselves already report after-tax information, but third parties do, as well. The third parties that produce information on after-tax returns are able to do so because mutual funds already provide all of the information necessary to compute after-tax returns. All funds disclose in their prospectuses and annual reports their portfolio turnover rates and their dividends and capital gains distributions per share for each of the last five fiscal years. From this information, anyone can estimate after-tax returns.

These private sector initiatives make it clear that the SEC has not identified a problem requiring regulation. In the absence of an SEC requirement, the market provides information at least as good as what the SEC is proposing. Even if no party currently

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[5] *Request for Comment*, p. 3.
[6] http://majestic.vanguard.com/FP/DA/0.1.vgi_FundAfterTaxSim/?AFTER_TAX_CALC=SIMPLE.
[7] This feature can be accessed by selecting a fund starting at the following internet address: http://personal400.fidelity.com:80/products/funds/.
[8] http://www.charlesschwab.com/SchwabNOW/SNLibrary/SNLib122/SN122mainMiniHome/0,4525,504,00.html
[9] http://www.eatonvance.com/frames/mutualinvestor.html
[10] http://www.morningstar.com/.
[11] http://www.personalfund.com/mfcc.html.

produced calculations of after-tax returns, all of the information necessary to do so is currently available. Indeed, that is why third parties are able to calculate after-tax returns.

The SEC's justification for this new disclosure requirement is weak. Its only stated standard is that the information be deemed "helpful" to investors in making investment decisions. But the SEC has no way of identifying information that meets this standard except by observing what happens in the market. If a piece of information is truly helpful to investors, one or more of the thousands of mutual funds will find it in its own economic interest to produce that information. In this case, a fund that is particularly tax efficient would benefit from advertising that efficiency if investors truly value tax efficiency. Competition among funds, then, would determine whether and to what extent after-tax returns would be made available. The SEC's intervention to require all funds to disclose after-tax returns would be redundant at best.[12] Furthermore, the requirement would weaken the incentives for funds to expand and improve on the information they provide consumers. Not only would the incentives be weakened, but the SEC's requirement could foreclose *better* information from being provided in the future.

IV. Costs and Benefits

The SEC recognizes that there will be some direct costs to the mutual fund industry (and therefore to investors) resulting from this new disclosure requirement, and it also recognizes that there may be some indirect costs. According to the SEC, the costs 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. As for indirect costs, the SEC acknowledges that the proposed requirement could cause existing funds to alter their investment strategies to invest in a more tax-efficient manner and that this might impose costs. While the SEC has not quantified these costs, they are unlikely to be justified by the benefits.

The SEC identifies several types of benefits, all of which are illusory. The first benefit claimed by the SEC is that the standardized after-tax returns would allow investors to compare funds based on their after-tax performance and that this could lead to the development of new tax-efficient funds or improved tax-efficiency of existing funds. As described above, investors have the ability to compare funds today based on their tax-efficiency. The development of new tax-efficient funds or improved tax-efficiency of existing funds would result if there were in fact sufficient demand among investors for more tax-efficient funds, and this would happen regardless of whether the SEC adopts or discards its proposal. In fact, as noted in the proposal, some fund groups have already launched new funds that use more tax-efficient portfolio management strategies. It should be noted that most fund investments (excluding money market funds) are held in non-taxable accounts. While the SEC proposal would permit a fund to omit the after-tax

[12] Whether the SEC's broader disclosure program is well justified is beyond the scope of this comment.

information in a prospectus used exclusively to offer fund shares to such accounts, this just means that, in most cases, the fund would have to maintain two sets of prospectuses. The fund, then would have the choice of incurring the costs of maintaining the two sets or producing just one prospectus for all types of accounts, in which case, the after-tax information would be worthless at best to the non-taxable accounts.

One should also remember that many mutual funds have already developed various funds for those who are sensitive to tax consequences of their investments. On the other hand, many mutual fund accounts are retirement accounts or rollover accounts, where the immediate tax implications are not relevant to the investor at this particular time. In either of these cases, SEC mandated disclosure would provide little, if any, benefit.

The second benefit claimed by the SEC is that standardization of after-tax returns would help prevent confusion among investors. However, investors are not all the same. Not only are their investment objectives and incomes different, but their levels of understanding and other desires for tax efficiency also vary. For investors who understand how taxes affect investments, standardization will not be helpful. These investors will want information specific to their personal tax situations (including their federal and state tax brackets) and their intended holding periods. The total tax consequence to an investor is more complex than the simple world assumed by the SEC. It is a function of both the results and timing of the fund's portfolio trades and of the investor's own fund transactions. In addition, the tax consequence cannot be understood without considering the investor's other investments and the extent of capital gains and losses from them. To the extent the SEC proposal addresses this interaction, it does so in a confusing and inconsistent manner. It proposes to treat capital gains as if there is no offsetting loss, yet it would treat losses as if there is a fully offsetting capital gain. This is just one assumption the SEC must make in order to achieve standardization, but the price of standardization is ignored.

For investors who do not understand how taxes affect investments, standardization may add more confusion than it eliminates. In order to understand what is conveyed by standardized after-tax returns, one must understand all of the assumptions that were required to achieve standardization. An investor that does not understand these assumptions and how they relate to his personal tax and investing situation may be confused or even misled by the standardization. In any event, there are already available sources for standardized after-tax returns, and there are sources that allow investors to alter some of the assumptions required by standardization. Finally, one point of confusion for investors today relates to the timing of their investment in a mutual fund, and the SEC's proposal would do nothing to clear this up. An investor who purchases a fund shortly before the fund distributes a realized gain will be hit with a tax bill that may be unanticipated and therefore confusing. The SEC's proposal does not address this and may even confound the confusion by lulling investors into a false sense of security based on the fund's disclosed after-tax returns.

The third benefit claimed by the SEC is that the new disclosure requirement will increase the amount of after-tax information available to investors and that investors will not have to rely on third parties for such information. It is not clear why this is characterized as a benefit. More information is worthless if it is duplicative. Furthermore, the SEC offers no explanation of why reliance on third parties is a bad thing.

The final benefit claimed by the SEC is that the new disclosure requirement will increase investors' understanding of the magnitude of tax costs and how they affect fund performance and that this increased understanding should enhance investor confidence in the fund industry. As explained above, many mutual funds and third parties already provide similar or better information, and the standardized after-tax returns the SEC proposes to require may be more misleading than helpful. As for enhancing investor confidence in the fund industry, the industry has incentives to enhance investor confidence. The information already being provided is evidence of the industry's responsiveness to their consumers.

The net benefits that could be attributed to the SEC's proposed new disclosure requirement are zero at best, and that would only be the case if the new disclosure requirement were completely redundant. In fact, the benefits appear to be non-existent and the costs positive. The net benefits, therefore, can only be negative.

V. Conclusions

The SEC has not justified its proposal to require mutual funds to report standardized after-tax returns. Its only stated criterion in developing the proposal is that the information be deemed "helpful" to investors in making investment decisions. But the SEC has no way of identifying information that meets this standard except by observing what information is brought forth by the private sector. It has not identified any market failure that would warrant regulatory action. On the contrary, the SEC's proposal is an attempt to mimic the successes of the market.

The private sector has already responded to demand by investors for information on after-tax returns, and the SEC's one-size-fits-all standard cannot supplant the response of the market to investor demands. Not only does this approach weaken the incentives to produce different kinds of information that could be of value to certain investors, it may also limit the development of more and better information to meet investors' ever changing needs and desires. As a result, the proposed disclosure requirement will offer no benefits not already provided by market participants, but will impose real costs on investors.

More and more Americans are investing in mutual funds; however, the standardized information proposed in this rule will not make them better off. Market participants are responding to the varied information and investment needs of different investors more efficiently than these requirements would. The SEC should withdraw its proposal.

Appendix I

RSP Checklist

SEC Proposed Disclosure of Mutual Fund After-Tax Returns

Element	Commission Approach	RSP Comments
1. Has the Commission identified a significant market failure?	The SEC believes it is necessary for investors to understand the tax consequences of investing in mutual funds. It proposes to require mutual funds to report standardized after-tax returns. **F – Unsatisfactory**	The SEC's release does not identify any market failure and does not make a case for intervention. Indeed, the release describes initiatives by the private sector that make it clear there is no market failure. The only failure may be a government failure in the form of a high tax burden and complex tax code.
2. Has the Commission identified an appropriate federal role?	The SEC claims authority to impose comprehensive disclosure requirements on mutual funds. It describes related disclosure requirements it has already imposed under its authority to regulate mutual funds granted by the Investment Company Act of 1940 and the Securities Act of 1933. **B – Good**	The SEC's proposal represents an extension of existing disclosure requirements. Its legal authority to do so is clear.
3. Has the Commission identified alternative approaches?	The SEC identifies a number of alternatives and solicits comment on those alternatives. **C – Satisfactory**	With the exception of allowing the market to develop and deliver the information tailored to differing investor desires, the alternatives considered deal primarily with the specifics of what is to be disclosed and the format for disclosure.

Element	Commission Approach	RSP Comments
4. Does the Commission attempt to maximize net benefits?	The SEC's release claims that there will be benefits to investors if its proposal is adopted. It recognizes the direct and even some indirect costs. **D – Poor**	Although the SEC release identifies several private sector initiatives to provide similar information to investors, it fails to recognize that such private sector initiatives produce the same or greater benefits. The benefits, therefore, are zero, and the net benefits are negative.
5. Does the proposal have a strong scientific or technical basis?	The SEC's release does not explain any scientific or technical basis for its proposal. **F – Unsatisfactory**	The proposal is not based on any theory of market failure. The basis is simply the SEC's belief that the information will be "helpful" to investors.
6. Are distributional effects clearly understood?	Distributional effects are not considered. **C – Satisfactory**	All investors will bear the costs of the required disclosure, but many investors will receive no benefits. For example, tax-exempt investors will receive no benefits.
7. Are individual choices and property impacts understood?	The SEC's proposal considers individual choice only with regard to the different tax rates that might apply to different individuals. The property impacts of the proposal are not significant. **D – Poor**	The private sector has developed information and tools that can be used by individuals to measure tax consequences applicable to their own personal situations. The SEC, however, seeks standardization.