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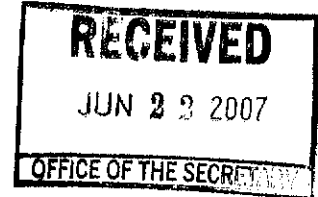
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OFFICE OF THE DIRECTOR
INVESTMENT MANAGEMENT DIVISION

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June 13, 2007



Robert Plaze
Associate Director
Division of Investment Management
U. S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

4-542

Re: Recommendations Regarding Amendments to Rule 19a-1

Dear Mr. Plaze:

The Investment Company Institute¹ is submitting for your consideration recommendations to amend Rule 19a-1 under the Investment Company Act of 1940. As you know, Rule 19a-1, which governs how a fund calculates and discloses the sources of its distributions, has not been revised substantively since its adoption in 1941. Since that time, technological advances, such as the Internet, have altered dramatically the way funds provide, and shareholders access, information. The types and complexity of investments made by funds, the accounting and tax treatment of these investments, and fund distribution practices also have changed significantly. The Institute has worked extensively with its members to develop recommendations that would update Rule 19a-1 to reflect these developments. The revisions we recommend below will permit funds to communicate more effectively with their shareholders, and shareholders to more readily access and compare information on fund distributions.²

¹ The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter.

² In an attachment to this letter, we have provided text of amendments to Rule 19a-1 that would need to be made to effectuate our recommendations. We recognize that both Rule 19a-1 and Rule 19b-1 are intended to enhance shareholder understanding of the nature of fund distributions from sources other than net investment income. Our proposed amendments to Rule 19a-1 would not address all of the issues encountered by closed-end funds that offer, or seek to offer, managed distribution plans pursuant to Section 19(b) exemptive orders. The Commission staff recently issued a revised set of conditions for closed-end funds seeking these orders. See Letter from James M. Curtis, Branch Chief, Division of Investment Management, U.S. Securities and Exchange Commission to Dorothy M. Donohue, Senior Associate Counsel, Investment Company Institute, dated December 21, 2006. We urge the Commission to consider proposing amendments to Rule 19a-1 and Rule 19b-1 concurrently and to propose amendments to Rule 19b-1 that are more flexible than the conditions recently issued by the staff. See, e.g., Letter from Dorothy M. Donohue, Senior Associate Counsel, Investment Company Institute to Cate Marshall, Senior Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated November 17, 2006.

Background and Summary of Recommendations

Section 19(a) requires the payment of any dividend, or a distribution in the nature of a dividend payment, to be accompanied by a written statement, (a "Section 19(a) Notice") that adequately discloses the source(s) of a payment if it is made from any source other than accumulated undistributed net income. Rule 19a-1(a) requires the Section 19(a) Notice to be on a separate piece of paper, and to clearly indicate what portion of the payment is from: (1) net income; (2) net profits from the sale of securities or other properties; and/or (3) paid-in surplus or any other capital source. Section 19(a) and Rule 19a-1 are intended to protect fund shareholders from mistakenly believing returns of capital or distributions of capital gains are income of a recurring nature.³ Commission staff recently reiterated the importance of this requirement, stating that it is a basic and fundamental requirement to accompany the payment of any distribution from a source other than net income with a written statement identifying the source of the payment.⁴

The objective of Section 19(a) can be achieved by requiring funds to disseminate information about distributions through the Internet within a reasonable amount of time after a distribution is made and in periodic shareholder communications. We therefore recommend that the Commission update Rule 19a-1 to permit funds to satisfy their disclosure obligations by posting the required information on their own, or an affiliate's, website within a reasonable amount of time after a distribution and additionally transmitting the required information to beneficial shareholders no less frequently than quarterly in account statements or other written communications.

We also recommend clarifying Rule 19a-1 to prescribe the accounting treatment for calculating the sources of fund distributions. A fund's distribution generally should be treated as arising first from net investment income (a book concept) and calculated under generally accepted accounting principles ("GAAP"). Amounts distributed in excess of net income should be treated as other taxable income and net realized gains (*i.e.*, capital gains) so long as they are supported by earnings and profits (calculated on a tax basis). The remainder of the distribution, if any, should be treated as a non-taxable return of capital as determined for federal income tax purposes.⁵ Rule 19a-1(e) should be amended to clarify that any revision to amounts previously subject to Section 19(a) reporting be made cumulatively. Finally, we recommend providing an exception from Section 19(a) Notice reporting for *de minimis* amounts of capital gain or return of capital.

³ See, e.g., Hearings Before a Subcommittee of the Committee on Banking and Currency of the United States Senate on S.3580, 76th Cong. (3rd Session) 275, 278 (1940).

⁴ See, e.g., Andrew J. Donohue, *Keynote Address at 2007 Mutual Funds and Investment Management Conference* (March 26, 2007).

⁵ Reporting return of capital on a tax basis is consistent with AICPA Statement of Position No. 93-2, *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies*, as incorporated into and superseded by AICPA Audit and Accounting Guide for Investment Companies (May 1, 2006), paragraphs 12.31-12.38 ("ROC-SOP").

The recommended approach will improve the comparability of Section 19(a) Notice information, alleviate shareholder confusion, and provide shareholders with more meaningful information about fund distributions.

Recommendations for Improved Disclosure

Internet Disclosure. We recommend amending Rule 19a-1 to require funds to post their Section 19(a) Notices on the Internet. Under our proposal, prior to initial posting, closed-end funds would be required to disclose by means of a press release that Section 19(a) Notices will be posted to a specified website, while mutual funds would be required to make this disclosure in their prospectuses.⁶ All funds would be required to disclose in their semi-annual and annual shareholder reports the Internet availability and location of Section 19(a) Notices. Funds would be required to keep their Section 19(a) Notices on the website for at least twenty-four months from the date of posting.

Posting Section 19(a) Notices on the Internet will benefit fund shareholders. A great majority of fund shareholders use the Internet on a regular basis including for financial purposes.⁷ Making this information available through the Internet will enable shareholders to access information about the sources of their distribution contemporaneously with receipt of the distribution.⁸ Shareholders also may review the information whenever they wish without concern for physically storing and retrieving written notices, and easily put it in context with other information about the fund available on the Internet. Internet posting also will benefit prospective investors, who otherwise will not have access to Section 19(a) Notice information, and third parties collecting and analyzing the information to the benefit of shareholders and the market. We believe the benefits of posting this information on the Internet would exceed the cost of this additional reporting obligation.

Periodic Written Statements. Section 19(a) provides that the payment of any dividend or distribution be "accompanied" by a written statement. The Commission staff already has recognized that the purposes of Section 19(a) can be satisfied when funds inform shareholders of

⁶ Unlike mutual fund shareholders, closed-end fund shareholders that purchase shares in the secondary market do not receive the fund's prospectus upon or closely following investment. Therefore, closed-end funds would disclose the availability of Section 19(a) Notices through press releases. Under our proposal, all funds would be required to make this same disclosure in shareholder reports. Because shareholder reports are distributed semi-annually, shareholders would be informed of the Internet availability of Section 19(a) Notices by means of a shareholder report no later than eight months after their initial purchase.

⁷ See Investment Company Institute, *Ownership of Mutual Funds and Use of the Internet, 2006*, Research Fundamentals, Vol. 15, No. 6, October 2006 at pp. 8 and 9; and Investment Company Act Rel. No. 27671 at p. 8 (January 22, 2007) (permitting proxy statements to be made available on the Internet).

⁸ Using the Internet in this context is consistent with the Commission's efforts to "enhance[] the efficiency of the securities markets by allowing for the rapid dissemination of information to investors and financial markets in a more cost-efficient, widespread, and equitable manner than traditional paper-based methods." See Investment Company Act Rel. No. 21399 (October 6, 1995) (permitting the delivery of prospectuses, annual reports, and proxy solicitation materials through electronic media). See also IC Rel. No. 27671 (January 22, 2007) (permitting issuers to post proxy materials on a website if shareholders are provided with a notice informing them that the materials are available and explaining how to access them).

the source(s) of distributions on, or together with, quarterly account statements or on check stubs.⁹ We recommend that the Commission codify this relief in Rule 19a-1. Consistent with this relief, we urge the Commission to use its exemptive authority to additionally permit funds to provide shareholders with information about distributions no less frequently than quarterly in any other type of written communication mailed (including by electronic mail) either together with, or separately from, account statements.¹⁰

Our recommended approach will permit funds to communicate distribution information to beneficial shareholders in a cost-efficient manner that takes into account how shares are distributed. For example, funds sold directly to beneficial owners may choose to transmit information to them on or with account statements or distribution checks.¹¹ Transmitting information to beneficial owners in this way generally is not an option for broker-sold funds. Brokers prepare and send account statements to each customer that include relevant information about the customer's fund and other brokerage account holdings. Our members report that it is not always reliable or possible to include Section 19(a) Notice information on or with brokerage statements. Brokerage statements generally have three fields for reporting distribution information. The fields identify income, short-term capital gain and long-term capital gain that has been distributed for the period covered by the statement.

Our members report that it will be a challenging and lengthy process to work with brokers to modify the format of their statements. It similarly would be difficult to convince brokers to mail a separate Section 19(a) Notice together with brokerage statements. The flexible

⁹ See Investment Company Institute, SEC No-Action Letter (pub. avail. July 22, 1996) (permitting funds to inform shareholders of the source(s) of distributions on, or together with, quarterly account statements if the distributions are automatically reinvested in fund shares or are directed to a bank or brokerage account or to a third party or on a check stub for funds that pay distributions by check). See also IDS Bond Fund, Inc., et al., IC Rel. Nos. 15545 (Jan. 16, 1987) (notice) and 15581 (Feb. 13, 1987) (order) (permitting funds that pay monthly distributions to include Section 19(a) Notice information in quarterly account statements; Standard & Poor's/Intercapital Liquid Asset Fund, Inc., IC Rel. Nos. 9342 (Jul. 6, 1976) (notice) and 9397 (Aug. 13, 1976) (order) (permitting a money market fund to make daily credits of accrued income to shareholder accounts but to provide Section 19(a) Notice information in quarterly or monthly statements).

¹⁰ Section 6(c) of the Investment Company Act provides the Commission with broad authority to conditionally or unconditionally exempt any person, security or transaction from any provisions of the Investment Company Act or of any rule thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policies and provisions of the Investment Company Act.

¹¹ We recommend permitting all funds, including direct-sold funds, to disclose Section 19(a) Notice information either on, together with, or separately from account statements. Our members report that it is important to retain the flexibility to report net investment income on a tax basis in account statements because this information is important for beneficial owners for tax planning and other purposes. Under our proposal, a fund would be permitted to disclose net investment income on a tax basis in account statements. If its distribution for a particular period also consisted of capital gain or return of capital, the fund additionally would be required to transmit to beneficial owners Section 19(a) Notice information either on account statements or other written communication (which could include a confirmation under Rule 10b-10 under the Securities Exchange Act of 1934). We see no reason not to permit this flexibility.

approach we recommend would permit funds to work with broker dealers to develop efficient and effective ways to transmit distribution information to beneficial shareholders.¹²

Under our proposal, funds that make monthly distributions would achieve a significant cost savings by being permitted to transmit Section 19(a) Notice information to beneficial shareholders in quarterly written statements. Our research indicates that quarterly disclosure would cost approximately \$1.84 per shareholder account per year as compared to \$5.52 per shareholder account per year for transmitting this information to beneficial owners monthly.¹³ The cost of sending the notices monthly clearly exceeds any corresponding benefit, particularly given that shareholders would be able to access this information on the Internet at any time.

We believe that each of the methods described above, particularly when coupled with Internet disclosure would accomplish the purpose of Section 19(a), which is to afford shareholders adequate disclosure of the sources from which dividend payments are made.

Recommendations For Determining Reportable Amounts

We recommend amending Rule 19a-1 to standardize calculations for Section 19(a) reporting as follows:

- Determine net income by reference to net investment income (a book concept);
- Treat a distribution as always being paid first from net income, unless management designates otherwise;
- Report any amount paid in excess of net income as other taxable income and net realized gains to the extent the fund has earnings and profits (calculated on a tax basis) to support the distribution;
- Report the remainder of the distribution as a return of capital (a tax concept);
- Revise Section 19(a) Notices (as needed) cumulatively; and
- Exclude from reporting otherwise reportable amounts that are *de minimis*.

Our members report that there is considerable confusion among their shareholders because the information they receive on their IRS Forms 1099 differs from the information in their Section 19(a) Notices. These differences arise, in part, because the Internal Revenue Code of 1986, as amended (the "Code") requires funds to provide shareholders with information

¹² Our amendments would require broker-dealers and banks to forward Section 19(a) Notice information to beneficial owners of fund shares. This is consistent with rules requiring these entities to forward proxy materials and shareholder reports to beneficial owners. *See, e.g.*, Rule 14b-1(b)(2) under the 1934 Act.

¹³ The Institute gathered information on the fifty-four closed-end funds with managed distribution plans. Of these funds, twenty-eight have monthly distribution plans. To mail Section 19(a) notices to beneficial shareholders, these funds would incur an annual cost of approximately \$5.52 per shareholder account. Twenty-six funds have quarterly distribution plans. These funds would incur an annual cost of approximately \$1.84 per shareholder account. We estimate that printing will cost 5 cents per account and postage will cost 41 cents per account, for a total of 46 cents per account per mailing. We do not have data on the frequency with which fund shareholders have consented to receive material from their brokers electronically. For those shareholders that have opted for e-delivery, costs would be less than for those who receive materials through the mail.

regarding the tax character of distributions received to help them properly calculate their income tax returns.¹⁴ Section 19(a) reporting, in contrast, is intended to ensure reporting of non-recurring amounts, based on "good accounting practice" (which may vary from the tax laws). Funds may realize income from a variety of transactions that do not fit into the same categories for tax and Section 19(a) reporting purposes. These book-tax differences result in inconsistent characterization of distributions. Inconsistent characterizations can be particularly confusing to shareholders when Forms 1099 and Section 19(a) Notices are sent in close succession, as they are when a fund makes a single annual distribution in December. Complete consistency using "pure" tax numbers or "pure" book numbers, however, is not feasible.

Ambiguities in the guidance for determining sources of distributions result in funds taking various approaches to calculating information for Section 19(a) Notices. As a consequence, shareholder confusion may arise not only from differences between a single fund's Form 1099 and Section 19(a) Notice, but also from differences in how each fund calculates the sources of its distributions. By clarifying the standard that applies, the comparability of Section 19(a) Notices among funds will be enhanced, and shareholder confusion will be diminished.

Under our proposal, Section 19(a) would be administered by applying "good accounting practices" that are neither pure book nor pure tax. These clarifications will preserve fully Section 19(a)'s objective of ensuring reporting of amounts that may not be recurring in nature without creating unnecessary inconsistencies between Section 19(a) Notices and IRS Forms 1099. Our approach, which was developed with extensive input from our members, is discussed in greater detail below.

Determining Net Income. We recommend that net income be determined by reference to net investment income (a book concept). Net investment income is an appropriate measure for Section 19(a) purposes because it includes only amounts (*e.g.*, interest and dividends) that are recurring in nature. While the amount that a fund distributes as net investment income will vary with changing interest rates and dividend practices, these variations are contemplated by Section 19(a).

Distributions First from Net Income. We recommend generally treating a distribution as being paid first from, and to the extent of, undistributed net income for the current or preceding fiscal year. This will clarify uncertainty that currently arises, among other times, when the ROC-SOP is applied for Section 19(a) purposes. Specifically, concern has arisen that a Section 19(a) Notice may be required if a fund with ordinary losses for tax purposes (such as from certain foreign currency transactions) distributes its net investment income. For example, assume a fund distributes 10 cents per share, and the fund has net investment income from dividends of 10 cents per share and foreign currency losses of 2 cents per share. Some have questioned whether the ROC-SOP would require a fund to send a Section 19(a) Notice reporting a 2 cent return of capital, even though the entire distribution is supported by net investment income. Our

¹⁴ Among other things, funds must report on IRS Form 1099 (by January 31 of the year following the year of distribution) the amount of the distribution that is treated as ordinary taxable (or tax-exempt) income, long-term capital gain and/or "nondividend distributions" (*i.e.*, return of capital), all as calculated under the Code.

recommendation will clarify that a Section 19(a) Notice is not required under these circumstances.

There may be situations when a fund with undistributed income will nevertheless need to designate a distribution as being from a different source. For example, a fund that (1) has undistributed income for the current year and undistributed net capital gain realized during the preceding year and (2) wants to distribute the latter amount pursuant to Code Section 855 (which would enable it to deduct that distribution from the preceding year), would designate the distribution for Section 19(a) purposes as a capital gain distribution (*i.e.*, the second category listed under Rule 19a-1(a)).

Determining Other Taxable Income and Net Realized Gains. We recommend that Rule 19a-1 be amended to clarify that all distributions supported by earnings and profits, as determined for federal income tax purposes, that are in excess of net investment income be reportable as other taxable income or capital gain (*i.e.*, other taxable income or net realized gains from transactions in securities or other properties). This treatment will ensure that taxable distributions not out of net investment income are reported consistently – as taxable – in Section 19(a) Notices and Forms 1099. Items covered by this proposal will include all capital gains, both short-term and long-term, as well as foreign currency gains, passive foreign investment company (“PFIC”) mark-to-market income and other amounts required by the tax laws to be distributed to shareholders as taxable income.

Determining Return of Capital. We recommend that Rule 19a-1 be amended to clarify that return of capital be determined by reference to tax principles. The ROC-SOP applies this concept to investment company financial reporting and results in funds reporting a return of capital in their financial statements only when they have a tax return of capital. By applying tax principles to determine returns of capital, the ROC-SOP reduces potential shareholder confusion. Under the ROC-SOP, any distribution supported by a fund’s earnings and profits cannot be a return of capital. Thus, a shareholder will not receive a Section 19(a) Notice regarding a return of capital unless, as of the distribution date, the fund lacks earnings and profits to support the distribution.¹⁵

We also recommend that funds be permitted to reasonably estimate earnings and profits for this purpose. This flexibility is critical because tax return of capital determinations are based on tax principles that are not, and cannot be, applied on a daily basis (*e.g.*, wash sale and PFIC mark-to-market adjustments). This flexibility would *not* enable funds to avoid sending Section 19(a) Notices; instead, the flexibility merely will permit a fund to report a distribution as from net profits if the fund reasonably estimates that its earnings and profits support the distribution. This flexibility will be particularly important for funds that seek to distribute currently their taxable income.

¹⁵ The ROC-SOP provides: “Although book returns of capital may occur, they have little relevance to investment company shareholders. In contrast, tax returns of capital have a high degree of relevance and must be separately reported to shareholders for income-tax purposes. To report book returns of capital when such returns have not occurred for tax purposes would be confusing to shareholders.”

Revisions to Previously Reported Amounts. We further recommend that Rule 19a-1(f) be amended to clarify that if a fund subsequently revises any amounts previously subject to Section 19(a) reporting, such revision will be done cumulatively and will be disclosed on the fund's next regularly scheduled Section 19(a) Notice. To illustrate, assume a fund that determines after the first quarter dividend is paid that it did not have the earnings and profits that it reported on the Section 19(a) Notice. In the first quarter, the fund distributed 10 cents per share and sent a Section 19(a) Notice reporting 6 cents of net investment income and 4 cents of realized gains. In the second quarter, the fund distributed 8 cents per share -- 5 cents from net investment income and 3 cents from realized gains. In calculating its second quarter dividend, the fund determined that only 2 cents of its first quarter distribution was from realized gains; the remaining 2 cents was return of capital. In this case, the Section 19(a) Notice for the second quarter would disclose on a cumulative year-to-date basis 11 cents of net investment income, 5 cents distribution from realized gains and a return of capital of 2 cents (*i.e.*, 2 cents from the first quarter). No obligation would exist to send amended Section 19(a) Notices to any shareholder who had redeemed all shares in the fund between the mailing of these two Section 19(a) Notices. Sending them this information would serve no purpose.

De Minimis Standard. We recommend that Rule 19a-1 be amended to provide that *de minimis* distributions of otherwise reportable amounts be excluded from the reporting obligations of Section 19(a). A distribution of otherwise reportable amounts will be deemed *de minimis* if the total amount of the distribution less the amount of net income does not exceed the greater of (i) ten percent of the total amount of the distribution (calculated as a percentage of the fund's cumulative year-to-date distributions) or (ii) one penny per share ("*De Minimis Standard*").

As noted earlier, Section 19(a) was enacted to prevent fund shareholders from receiving a false impression of a fund's expected return. When the portion of a distribution in excess of a fund's net income is small, the risk of misleading shareholders regarding fund performance is remote. Streamlining the notification requirements in this manner also has the benefit of reducing the compliance burden on funds and eliminating any costs associated with preparing Section 19(a) Notices.¹⁶

The *De Minimis* Standard also will provide funds with flexibility when making distributions before the end of the period to which the distribution relates. For example, funds typically make their year-end distributions (of essentially all of their calendar-year income) well before December 31. Rule 19a-1 presently allows a fund to determine (or reasonably estimate) a dividend's source(s) "to the close of the period as of which it is paid" -- which would be December 31 in the example above.¹⁷ The *De Minimis* Standard will provide additional comfort (and prevent subsequent reporting clarifications) if the fund's determination/estimate is not sufficiently precise.

¹⁶ The costs of sending Section 19(a) Notices will vary depending which delivery method the Commission requires (*i.e.*, Internet posting, quarterly statements, Section 19(a) Notices with each distribution).

¹⁷ We recommend that the SEC clarify this point as part of its rulemaking initiative.