INCREASING DISCLOSURE TO BENEFIT INVESTORS

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCE AND HAZARDOUS MATERIALS

OF THE

COMMITTEE ON COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

ON

H.R. 887 and H.R. 1089

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INCREASING DISCLOSURE TO BENEFIT INVESTORS

FRIDAY, OCTOBER 29, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2123, Rayburn House Office Building, Hon. Paul E. Gillmor presiding.

Members present: Representatives Gillmor, Markey, and Cox.

Staff present: Brent DelMonte, majority counsel; David Cavicke, majority counsel; Brian McCullough, majority professional staff; Robert Simison, legislative clerk; and Consuela Washington, minority counsel.

Mr. GILLMOR. The committee will come to order and we will proceed with the first bill. We have two bills up today and two panels, and we will do opening statements on the first bill, and then do the panel and then the same procedure on the second bill.

I might tell those that are here that attendance is a little weak today because Congress is not in session. We were scheduled to be recessed, and when that happens, members leave town.

I want to thank members on both panels for coming. I know that a number of you have come from some distance and we very much appreciate your lending us your time and your expertise.

The first bill is H.R. 887, improved disclosure of charitable contributions by corporations, and I want to thank both Chairman Mike Oxley and ranking member Ed Towns who have cosponsored this legislation which I have introduced.

Over 60 years ago, we determined as part of national policy that shareholders are entitled to receive relevant information from corporate management. Corporations give more than $8.5 billion per year in charity, and there is no reason why shareholders should be denied knowledge of that information.

Under current law if a corporation donates money to a charitable organization, the corporation is under no obligation to reveal anything about those gifts. Because those gifts are donated from shareholder earnings, a reasonable disclosure requirement is a matter of accountability. Now some corporations voluntarily disclose this type of information, including Eaton Corporation which is testifying today, and I want to commend those who voluntarily do disclose.

This is not an issue about which groups receive charitable contributions from corporations, it is an issue of shareholder rights. Shareholders are the owners of a company's assets, and nothing in my legislation questions a company's commitment to social responsibility. Likewise, nothing in the legislation prohibits or restricts management's right to make donations or assess to whom or how much. I simply believe that shareholders have a right to review management's decisions and rationale.

I have heard all of the arguments from companies and charities that feel threatened by this legislation. It is too costly, too burdensome. Shareholders are not interested. The amount of contributions is insignificant, given out to local companies, and more.

Of the Fortune 100 companies which have provided SEC information about charitable giving, 53 percent of the number of cash contributions were $2,500 or less. A threshold of just $2,500 would require those companies to report less than half their contributions, and I would imagine that smaller companies would have to report less than that. Contributions of $2,500 or less, however, accounted for less than 4 percent of the total dollar amount. Less than 2 percent of the contributions exceed $100,000, but those contributions represent 46 percent of the total amount contributed.

We are not talking about disclosing checks to the local boys' and girls' clubs, we are talking about significant contributions from shareholder earnings, and I have spent a lot of time working with both business and charity groups to find a workable disclosure requirement.

The subcommittee did extend an invitation to the Business Roundtable to be with us today. I regret that they and a member company were not able to be here today, but we have met with them in the past and their views are certainly welcome at any time in the future as well.

The fact is companies that do voluntarily disclose their giving haven't had those problems. Arguments raised from companies against the bill come mostly from managers who don't want to tell shareholders where they are giving the money away and use those arguments as excuses. If a CEO's spouse is the president of the Hula Hoop Foundation and the company gives $1,000 dollars to the Hula Hoop Foundation, and the company doesn't manufacture, sell, promote or have anything to do with Hula Hoops, then shareholders derive absolutely no benefit from those donations. Of course there is a natural self-interest in that case for the CEO to keep the donation out of the public eye. Transparency and integrity are the foundations upon which shareholders take a stake in our equity markets.

Today over one-half of American families are invested in the stock market in one form or another. Millions of Americans are owners of our publicly held companies, and as more and more Americans take advantage of corporate ownership to secure their financial future, they assume a greater role in responsible and judicious charitable giving. Shareholders cannot participate in this great tradition unless they have access to this information.

I requested that the SEC do a study on the feasibility of this bill, and the SEC did report back earlier this year and concluded, "The corporate charitable disclosure requirements in H.R. 887 would be feasible in that companies are capable of tracking and disclosing this information to investors."

I would also like to note a small utterance by the SEC Chairman in a 1995 speech on disclosure. Chairman Levitt began by quoting Samuel Johnson saying, "Where secrecy or mystery begins, vice or roguery is not far off."

I turn to the distinguished gentleman from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you very much, Mr. Chairman. And I thank you very much for ensuring that we would have this very important hearing this morning which I hope can ultimately lead to legislative action.

I am a cosponsor with you, Mr. Chairman, of H.R. 1089, The Mutual Fund Tax Awareness Act. This bill would direct the SEC to issue rules to ensure that mutual fund investors receive disclosure regarding the after-tax performance of their mutual funds. This type of information can be very useful to investors in combination with other types of disclosures required under existing rules in making an informed investment decision regarding the impact of capital gains on the overall performance of a mutual fund.

While such disclosures, like all historical data regarding the past performances of a fund, does not have precise predictive value, it is nevertheless useful and important for investors to receive that type of information.

The fact is because this industry is so competitive and because there are so many funds out there, factors such as fees and tax-adjusted performance can be a significant and material factor to an investor in choosing which fund to invest their money. The more information an investor has, the more likely they are going to make an informed decision. That is ultimately the only goal of this legislation. To put the information in the hands of the investor to as a result make them even more knowledgeable and then with the guarantee that nothing is guaranteed, they can make their investments in the mutual funds of their choice.

So I hope, Mr. Chairman, that we can move forward on that legislation. I look forward to hearing from expert witnesses and I yield back the balance of my time.

Mr. GILLMOR. Thank you, Mr. Markey.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. MICHAEL G. OXLEY, CHAIRMAN, SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS

Today this Subcommittee will focus on two bills drafted by my colleague, Congressman Gillmor. Both of these bills, which I cosponsor, would provide investors with better investment information by mandating certain disclosures. Because educated investors make better decisions than those without reliable information, these bills will benefit investors in our country and throughout the world.

The first bill we'll consider, H.R. 887, would require corporations to provide their shareholders with certain information about corporate giving. Responsible corporations play a major role in funding not-for-profit organizations, and no one in the Congress wants to see corporations stop these beneficial activities. At the same time, corporations are under no obligation to disclose to their shareholders where shareholder money is being donated, even if the money is being funneled to a not-for-profit on which a director or a director's spouse serves, or to groups opposed by the majority of shareholders. While many corporations have taken it upon themselves to provide their shareholders with information about their charitable giving, most corporations still do not. Since corporate gifts are donated out of shareholder earnings, it is only reasonable to provide shareholders with information about where the money, which would otherwise be returned to them in the form of a dividend, is being spent.

In our second panel we'll consider H.R. 1089, the Mutual Fund Tax Awareness Act, a bill which would provide mutual fund shareholders with better information about their funds' rates of return. According to Morningstar, 180 of the 756 all funds, or nearly one in four funds, which have been in existence for the past ten years have lost more than three percentage points per year on their claimed rates of return to taxes. The funds most likely to lose percentage points are those with high portfolio turnover, because if the fund manager is frequently turning over short-term gains in searching for better investments, the investors will have to pay taxes on this turnover on a yearly basis. Despite this fact, the overwhelming majority of funds still do not list performance figures on an adjusted, after-tax basis, even though they do list performance rates net of fees and expenses. This means that if an investor buys into a fund which claims a rate of return of 15%, but the investor isn't provided with information showing that the adjusted rate of return for the fund was only 10% after the investors paid their taxes, then that investor may have missed out on the opportunity of buying into a fund which better takes into account investor tax consequences when managing the fund.

I want to commend Congressman Gillmor on his hard work in drafting these bills. They reflect a reasonable compromise between competing interests. I look forward to working with the members of this Subcommittee to ensure that investors are provided better information about their investments.

PREPARED STATEMENT OF HON. TOM BLILEY, CHAIRMAN, COMMITTEE ON COMMERCE

Mr. Chairman: It goes without saying that investors, and potential investors, benefit from reliable investment information. This investment information takes many forms. Today's hearing will focus on one form of this information: mandated corporate disclosure. Specifically, this hearing will consider two bills drafted by my colleague, Congressman Gillmor.

The first bill upon which the Subcommittee will focus, H.R. 887, would amend the Securities and Exchange Act to require that corporations disclose certain information concerning their charitable giving. While there is no doubt that corporate giving is essential to the missions of many not-for-profits, at the same time it must be remembered that the money being given to these groups belongs to the shareholders, not the corporate board. It is important to give these shareholders more information about where their money is being spent, so we need to learn whether this bill would effectively accomplish that objective.

The second bill, H.R. 1089, would require that the S.E.C. amend their regulations to require improved disclosure of mutual fund returns. It is a common industry practice to report mutual fund performance figures net of expenses and fees, but not net of taxes. Given that many non-index funds experience a high rate of turnover in their portfolios yearly, because investors must pay taxes on this turnover the actual rate of return investors enjoy frequently is less than what is reported by the funds. Providing investors, and potential investors, with information about the after-tax effects of portfolio turnover will better enable investors to properly choose the mutual fund which best suits their investment needs.

Mr. Chairman, I commend Congressman Gillmor for his work on these bills, and you for scheduling this hearing. I look forward to hearing from our witnesses.

Mr. GILLMOR. We will proceed with Robert Thompson, who is from the University of Washington School of Law in St. Louis. Mr. Thompson.

STATEMENTS OF ROBERT B. THOMPSON, GEORGE ALEXANDER MADILL PROFESSOR OF LAW, WASHINGTON UNIVERSITY; AND JAMES L. MASON, DIRECTOR OF PUBLIC AND COMMUNITY AFFAIRS, EATON CORPORATION

Mr. THOMPSON. Thank you, Mr. Chairman. I am Robert Thompson of St. Louis, Missouri. I am a law faculty member at Washington University and Director of the Center for Interdisciplinary Studies at the Washington University School of Law. My statement is on behalf of myself and Professor Charles Elson who is a professor at Stetson University, a frequent writer about corporate governance and in fact a director to American corporations.

I speak this morning about H.R. 887 which would require corporate disclosure of charitable contributions. We believe that would be a vital and welcome addition to a well-functioning corporate system and could help ensure confidence and encourage participation in our Nation's capital markets.

The corporate forum permits a specialization of function between managers and shareholders. It is one of the most distinctive parts of corporate law that separates and facilitates an efficient management structure and it permits the corporation to adapt to changed circumstances which is essential in our modern economy.

At the same time, separation creates possible agency problems in that directors are given control over large pools of funds invested by the shareholders. Disclosure is the central mechanism used by Federal law to enable shareholders to effectively exercise their voting and other rights available to them under State corporate law. Disclosure of material charitable contributions, as would be required by H.R. 887, is consistent with the disclosure currently required under the Federal securities law. The more specific disclosure that would be required by this bill where there is a possibility of a conflict of interest as to the corporate insiders and the beneficiary of the corporate charitable contribution is consistent with the focus in Regulation S-K on disclosure relating to comment of interest generally.

As with other expenditures of corporate money, shareholders desire that charitable contributions reflect a corporate purpose and do not simply become a gift of corporate assets to benefit the managers who direct the funds, but with no financial or emotional benefit to the shareholders themselves and to their collective enterprise.

Today's corporate philanthropy sometimes functions to promote and aggrandize corporate managers with the benefit and the credit for the donations flowing to the individuals without any corresponding benefit to the entity and its owners.

Consider the well-publicized case of Occidental Petroleum. When its long-time CEO, Armand Hammer, was unable to obtain satisfactory terms as to the donation of his art collection to the Los Angeles County Museum of Art, he turned to the company, Occidental, to build a museum to house the collection. The cost of the new building, the renovation of space for the museum's use in Occidental's headquarters next door, and property taxes and annuities to help fund the museum's initial operations approached $100 million. The company received some public recognition in the form of the right to name and use certain space in the building and certain sponsorship rights. Many believe the gift did little for the corporation's financial prospects or its shareholders but did a great deal for Mr. Hammer's standing in the art community.

A challenge to this action under traditional State law corporate rules led to a settlement limiting the company's contributions. As required by appropriate corporate law procedures, the Delaware chancery court was asked to approve the settlement, but its language in doing so provides little reassurance as to the ability for the current legal structure to actively address the problem that you have mentioned this morning. The chancery said and I quote, "If the court was a stockholder in Occidental it might vote for new directors. If it was on the board, it might vote for new management. And if it was a member of the special committee, it might vote against a museum property.” But, the court continued, its options are limited in reviewing the proposed settlement and in fact the settlement was approved.

This story is sadly not alone in our corporate landscape. Generally if a manager directs substantial contributions out of corporate funds to a charity with whom he or she is personally involved, there is the potential of a conflict of interest. If the charity has no relationship with the entity’s business but provides the manager some form of personal benefit within the community, the possibility of self-dealing is real. Such a manager may not be the best steward of the shareholders’s resources. Knowledge of those facts would clearly be material to shareholders in evaluating the performance of directors and directly relevant to their providing proxies to the election of directors. Current Federal regulation provides for direct conflict transactions, but does not provide for disclosure of charitable donations. Shareholders, therefore, cannot readily ascertain the existence of such a conflict. The House bill will provide the facts necessary for determining either the existence of such conflict or even the simple misapplication of shareholders’ investment.

While the benefit of such disclosure is substantial, the corresponding cost is not. Every public company that makes such charitable contributions annually collects information regarding those donations for reporting to the appropriate State and Federal taxation authorities. Requiring the disclosure of charitable contributions over a threshold amount will require no more than the repetition of information already collected and transmitted to government agencies. The disclosure contemplated by the proposed legislation greatly benefits the shareholding public at very little potential cost to the reporting companies. The proposed legislation is a focused and targeted effort that can be implemented consistent with existing Federal approach to securities disclosures. We urge you to make them part of our Federal securities laws.

[The prepared statement of Robert B. Thompson follows:]

PREPARED STATEMENT OF ROBERT B. THOMPSON [1] AND CHARLES M. ELSON [2] REGARDING H.R. 887

H.R. 887 requiring corporate disclosure of material charitable contributions is a vital and welcome part of a well-functioning corporate governance system that can insure investor confidence and encourages active participation in the national capital markets. It makes necessary changes that can be implemented at a minimal cost.

The corporate form permits a specialization of function between directors and shareholders, for example, that facilitates an efficient management structure and permits the corporation to adapt to changed circumstances. At the same time, this

[1] George Alexander Madill Professor of Law and Director, Center for Interdisciplinary Studies, Washington University School of Law, St. Louis, Missouri. Professor Thompson has taught corporations and securities law for more than 20 years. He is co-author of a corporations casebook widely used in American law schools and is a former chair of the Section of Business Associations of the Association of American Law Schools.

[2] Professor of Law, Stetson University School of Law, St. Petersburg, Florida. Professor Elson specializes in corporate governance research and is a director of two publicly held American companies. He is a member of the Advisory Council of the National Association of Corporate Directors; he organized a national working group of lawyers, investors, and law professors to discuss possible language and approach for this bill in 1998 and a seminar on corporate philantrophy in 1997.

separation creates possible agency problems in that directors are given control over large pools of funds invested by the shareholders. Disclosure is the central mechanism used by federal law to enable shareholders to effectively exercise their voting and other rights available to them under state corporate law.

Disclosure of material charitable contributions as would be required by H.R. 887 is consistent with disclosure currently required under federal securities laws. The more specific disclosure that would be required when there is the possibility of a conflict of interest as to a corporate insider and the beneficiary of the corporate charitable contribution is consistent with the focus in Regulation S-K, for example, on disclosure relating to possible conflicts of interest.

As with other expenditures of corporate money, the shareholders desire that charitable contributions reflect a corporate purpose and do not become simply a gift of corporate assets that benefits the manager who directs the corporate funds with no financial or emotional benefit to the shareholders themselves and their collective enterprise. Today's corporate philantrophy sometimes functions to promote and aggrandize corporate managers, with benefit and credit for the donations flowing to the individuals without any corresponding benefit to the entity and its owners. Consider the well-publicized case of Occidental Petroleum Corporation.[3] When its longtime CEO Armand Hammer was unable to obtain satisfactory terms as to the donation of his art collection to the Los Angeles County Museum of Art he turned to Occidental to build a museum to house his collection. The costs of the new building, renovation of space for the Museum's use in Occidental's headquarters next door, property taxes and an annuity to help fund the museum's initial operations exceeded $100 million. The company received some public recognition in the form of the right to name and use certain spaces and certain sponsorship rights. Many believe that the gift did little for the corporation's financial prospects or its shareholders but did a great deal for Mr. Hammer's standing in the art community.

A challenge to this action under traditional state law corporate rules led to a settlement limiting the company's contributions. As required by appropriate corporate law procedures, the Delaware Chancery Court approved the settlement but in language that provides little reassurance for the ability of the current legal structures to adequately address this problem: "If the Court was a stockholder of Occidental, it might vote for new directors, if it was on the Board it might vote for new management and if it was a member of the Special Committee, it might vote against the Museum project. But its options are limited in reviewing a proposed settlement . . ."[4] This story is sadly not alone in our corporate landscape.[5]

Generally, if a manager directs substantial contributions out of corporate funds to a charity with whom he or she is personally involved there is the potential of a conflict of interest. If the charity has no relationship with the entity's business, but provides the manager some form of personal benefit within the community, the possibility of self-dealing is real. Such a manager may not be the best steward of the shareholders' resources. Knowledge of those facts would clearly be material to shareholders in evaluating the performance of directors, and directly relevant to their providing proxies for the election of directors. Current federal regulations provide disclosure for direct conflict transactions, but do not provide for disclosure of such charitable donations.[6] Shareholders therefore cannot readily ascertain the existence of such conduct, either malignant or benign. The House Bill will provide the facts necessary for determining either the existence of such conflicts of interest or even the simple misapplication of shareholders' investment. Information such as this is necessary to the shareholder's informed evaluation of company management which in turn is vital to a properly functioning capital market.

While the benefit of such disclosure is substantial, the corresponding cost is not. Every public company that makes such charitable contributions annually collects information regarding such donations for reporting to the appropriate state and federal taxation authorities. Requiring the disclosure of charitable contributions over a threshold amount will require no more than the repetition of information already collected and transmitted to governmental agencies. The disclosure contemplated by

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[3] See Kahn v. Sullivan, 594 A.2d 48 (Del. 1991); see also Nell Minnow, What's Wrong with These Pictures? The Story of the Hammer Museum Litigation, in *Law Stories* 101 (Gary Bellow & Martha Minnow, Eds. 1996).

[4] Sullivan v. Hammer, No. 10823, 1990 Del. Ch. LEXIS 119, at *12 (Del. Ch. Aug. 7, 1990) aff'd sub nom., Kahn v. Sullivan, 594 A.2d 48 (Del. 1991).

[5] See also Jayne W. Barnard, Corporate Philanthropy, Executives' Pet Charities and the Agency Problem, 41 N.Y.L.S. L. Rev. 1147, 1160-64 (1997) (examples of sizeable corporate contributions connected to CEO preferences).

[6] See Faith Stevelman Kahn, Legislatures, Courts and the SEC: Reflections on Silence and Power in Corporate and Securities Law, 41 N.Y.L.S. L. Rev. 1107 (1997).

the proposed legislation greatly benefits the shareholding public at very little potential cost to the reporting companies.

The proposed legislation is a focused and targeted effort that can be implemented consistent with the existing federal approach to securities disclosure. It applies only to reporting companies (and similar companies regulated under the Investment Company Act.) Subsection 1 requires disclosure of contributions to nonprofits when an issuer's director officer or control person (or a spouse of one of those) is a director or trustee of the nonprofit. It will require disclosure of contributions only above a threshold amount as designated by the Securities and Exchange Commission ("SEC"). Subsection 2 requires additional disclosure of the total value of contributions made by a corporation and individual disclosure above a threshold that will be designated by the SEC. Unlike the disclosure in the previous section, this disclosure would appear not in the proxy report sent to all shareholders but in a filing as designated by the SEC. Because the reason for such disclosures differ from the reasons for conflict of interest disclosure, the nature of the disclosure may also differ.[7]

These disclosures are consistent with, and considerably less complex than, existing disclosure as to conflict transactions as found, for example, in Item 404 of Regulation S-K. They reflect disclosure priorities found generally in Regulation S-K and other parts of the federal securities laws. We urge you to make them part of our federal securities law.

Mr. GILLMOR. Thank you very much, Mr. Thompson, and I want to announce that the record will remain open for others members to submit in writing their opening statements. James Mason from Eaton Corporation in Cleveland, Ohio.

STATEMENT OF JAMES L. MASON

Mr. MASON. Good morning, Mr. Chairman. Thank you very much for the opportunity to appear this morning and talk a little bit about H.R. 887.

I am Director of Public and Community affairs for Eaton Corporation, a global manufacturer headquartered in Cleveland, Ohio. It employs about 65,000 men and women worldwide at about 215 manufacturing sites.

Let me tell you about our overall contributions and community relations philosophy. As a global company, Eaton Corporation transcends national borders, crosses State lines and bridges cultural differences by providing jobs and economic stability. The company invests in itself and in the future with little fanfare. As background, we provided about $5 million last year to deserving nonprofit organizations and communities.

Each year we look at the many causes called to our attention by our employees and apply our knowledge and skills to determine where we can provide the most benefit to those in need. Our first commitment is in those cities and towns and communities where our employees live and work. We support programs that aid education and strengthen the community as well as help those with limited opportunities and few resources.

No less important than the dollars provided are the many hours that volunteers devote to making a difference in people's lives. This is part of the Eaton of which I am most proud. Across the company there are many unsung heroes who take the time to engage in these volunteer activities. Each year we honor those individuals with an award for community service named after one of our

[7] See Melvin Aron Eisenberg, Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, The Penumbra Effect, Reciprocity, The Prisoner's Dilemma, Sheep's Clothing, Social Conduct and Disclosure, 28 Stetson L. Rev. 1, 25 (1998).

former chairmen, who like many in our company have had a tradition of volunteerism.

It is clear as we approach the new millennium, technological advances have not provided the solutions to the human and social issues of our times. We have an opportunity and an obligation to strengthen the communities where we live and work and to help those less fortunate. To do less would be to deny that corporations have a mission beyond providing jobs and creating wealth. We believe otherwise, and we act on that belief.

Our employees consistently give of their time, talent, and finances to support a variety of noteworthy programs and organizations. Grants are frequently awarded to organizations recommended by our employees who are involved in leadership roles and who are in a position to ensure the effective use of the company's investment.

It has been our philosophy at Eaton to be open and candid in disclosing to whom our charitable contributions are made and the amount of our philanthropy. We do this in a volunteer manner and share this information with our board of directors, our employees and grant seekers. I have reports of our contributions, Mr. Chairman, with my testimony on our total philanthropy.

In addition to our voluntary disclosure, we also meet with our board of directors on an annual basis, a committee of our board of public policy and social responsibility; it is a chance to view firsthand the projects and priorities that we are funding.

But I am not sure, Mr. Chairman, that one size fits all. This works for a company such as Eaton. It has been in our history. We don't make that much in the way of corporate philanthropy that it is going to make a difference on the margin. We try to be supportive of the involvement of our people. That is where our money flows. I know that you have run some statistics as to whether this would have an impact on philanthropy. I am not sure, but I think anything that could have a possible chilling effect is something that we would not want to advocate.

I know in talking to colleagues within the philanthropic community, Mr. Chairman, we have a very different opinion on this issue. Disclosure, as it indicates, I think is good for the process. I think mandating the types of elements may not be, and I would not advocate that.

Thank you very much, Mr. Chairman.

[The prepared statement of James L. Mason follows:]

PREPARED STATEMENT OF JAMES L. MASON, DIRECTOR, PUBLIC & COMMUNITY AFFAIRS, EATON CORPORATION

INTRODUCTION

My name is Jim Mason and I am Director of Public & Community Affairs for Eaton Corporation. My company is a global manufacturer of highly engineered products that serve industrial, vehicle, construction, commercial, aerospace and semiconductor markets. Principal products include hydraulic products and fluid connectors, electrical power distribution and control equipment, truck drivetrain systems, ion implanters and a wide variety of controls. We are headquartered in Cleveland, Ohio—and employ 65,000 men and women at 215 manufacturing sites in 25 countries around the world. Our 1999 sales are expected to be nearly $9 billion.

BACKGROUND

I am providing testimony in regards to H.R.887 regarding disclosure of corporate charitable contributions sponsored by Congressman Paul Gillmor. Let me begin by telling you about Eaton and its overall contributions and community relations' philosophy.

As a global company, Eaton Corporation transcends national borders, crosses state lines and bridges cultural differences. By providing jobs and economic stability, the company invests in itself, in society and in the future. With little fanfare, Eaton provided nearly $5 million last year to deserving non-profit organizations and communities.

Each year we look at the many causes called to our attention by our employees and apply our knowledge and skills to determine where we can provide the most benefit to those in need. Our first commitment is to the cities, towns, and villages where our employees live and work. We support programs that aid education and strengthen the community as well as help those with limited opportunities and few resources.

Of no less importance than the dollars provided are the many hours that volunteers devote to making a difference in people's lives. This is the part of Eaton of which I am most proud. Across the company there are many unsung heroes who take the time to teach reading to the illiterate, coach little league softball, organize a school aid program or reach out in other ways to those in need. Each year we honor several of these volunteer leaders with the James R. Stover Awards for Community Service, named after one of our former chairmen, but there are many, many others who uphold this Eaton tradition of volunteerism.

As we approach a new millennium, it is clear that technological advances have not provided solutions to the human and social issues that trouble our times. We have an opportunity and an obligation to strengthen the communities where we live and work and to help those less fortunate. To do less would be to deny that corporations have a mission beyond providing jobs and creating wealth. We believe otherwise and we act on that belief.

Eaton employees consistently give of their time, talent and finances to support a variety of noteworthy programs and organizations. Grants are frequently awarded to organizations recommended by employees who are involved in leadership roles and who are in a position to ensure the effective use of the company's investment.

It's been Eaton's philosophy to be open and candid in disclosing to whom our charitable contributions are made and the amount of our philanthropy—we do this voluntarily and share the information with our board of directors, employees and grant seekers. Enclosed with this commentary are reports of contributions that reflect our total philanthropy.

What Congressman Gillmor is suggesting with H.R.887 is improved disclosure, openness and accountability—all very worthwhile goals. However, what is disturbing, in my opinion, is the provision that publicly held companies such as Eaton, would be required to list in our proxy statement, all contributions (amount to be determined by the SEC) to non-profit organizations that had a board member who is an executive of the corporation, or is an executive's spouse. Also, disclosure is required of the total amount of contributions in a year, along with the name of any non-profit receiving contributions exceeding a certain amount specified again by the SEC.

I can understand that possibly these provisions were intended to prevent some individuals from becoming too directly involved on certain "pet projects", but we want our executives and our associates actively involved with organizations and witnessing first-hand the delivery of services and providing oversight on governing boards. If the aforementioned provision is enacted, it is possible that a chilling affect will occur, not only would the non-profit experience some funding dilemmas, but active involvement would be lost as well.

Although we choose to disclose our philanthropy voluntarily (not in a proxy statement), many other businesses for a variety of reasons choose not to disclose in the same manner as Eaton. It's been suggested that added cost would result from the proposed mandates, I am not certain as to the amount, but it would have an adverse impact on corporate philanthropy. And, that is what we don't need today—in the era of unprecedented economic growth, more corporate philanthropy by new small and medium sized businesses should be encouraged to do more for others in need in our society.

Mr. GILLMOR. Thank you very much, Mr. Mason.

Let me ask both of you what would be, if any, the compelling public policy reason for shareholders not to know this information? Is there any?

Mr. THOMPSON. Shareholders care about how the corporate money is spent, and there is a question of materiality in terms of at what level they would be concerned, but the bill seeks to address that by not requiring every disclosure but only that over a threshold. That is in response to the main argument, obviously.

Mr. MASON. I think on that point, Mr. Chairman, our shareholders, at least through our board of directors, are fully informed and the report of contributions that we make available to the various public is open to shareholders. Do I send that to every shareholder of Eaton Corporation? I certainly do not. But it is available, Mr. Chairman, for them to review.

Mr. GILLMOR. One potential concern that you have raised is that it might have a chilling effect on contributions. Now there are other companies that publicly disclose, including some very big ones. Chevron is an example. But in your case, because you have been disclosing for years—and in fact I have seen your report, which is very good, and your disclosure goes far beyond anything that would be called for in this legislation—does the fact that Eaton discloses have a chilling effect on what you give?

Mr. MASON. No, I don't think it has a chilling effect. I guess I am a little concerned that the implication drawn in the legislation of either the chairman or a member of the board or spouse would—that there would be something sinister, and maybe that is not the intended consequence.

We do link a lot of our philanthropy, as you know, Mr. Chairman, with the involvement. We think that it is important that our people are not only giving of their own personal finances, but they are taking the time to have some oversight and governance on these organizations. I don't see anything wrong with that. I get concerned that if in the spirit of volunteerism we lose that pull by mandating certain types of openness beyond where we are open now.

I think I would rather present this material in this fashion than include it in a proxy statement, for example, is what I am saying. I think for every example that Professor Thompson gave relative to the situation about Mr. Hammer, I don't think that we see that in corporate America. I can't speak to that end of it, certainly.

Mr. GILLMOR. Let me ask Mr. Thompson, because you have been involved in this type of legislation and you have heard the arguments against the disclosure requirement. You have reviewed the previous bill that I have introduced, and I think many companies were surprised at how small a disclosure requirement we actually have in H.R. 887. But from your looking at the changes which have been made in this bill, do you think any of those cost or burden arguments have been alleviated in the current legislation?

Mr. THOMPSON. Yes, I think the changes from the prior legislation to this proposal speak to a number of concerns that were raised about cost and regulation.

This bill is disclosure which is common in lots of areas of corporate America. Companies do it all of the time. It only applies to specific disclosures when there is a specific conflict. There will be a threshold which can speak to the numbers that you made in your opening statement. If you eliminate all the small ones, it is not a large number. With those changes, the burden has been made much smaller.

Remember, the costs generally are not very great because the information is being collected to be given to the tax authorities relevant to tax returns. So I think that the changes have been very responsive to the concerns raised about the cost and impact.

Mr. GILLMOR. Thank you very much.

The gentleman from California, Mr. Cox.

Mr. COX. Thank you, Mr. Chairman.

I would like to thank our witnesses for being with us this morning, and I would like to thank Eaton for its enlightened policy. I think the reason that we are here this morning is to see whether or not Eaton's enlightened policy ought not to be the policy generally in a marketplace that is characterized by full disclosure.

Mr. Mason, I think I share your concern about anything that would have a chilling effect. I think the chairman's question about whether your enlightened policy and disclosure causes any chilling effect gets right to the heart of it. In your view it does not, but there are certain kinds of transfers of shareholder wealth for no value—which is what a gift is, it has to be in return for nothing—that obviously could violate the fiduciary duty of the officer or director, that obviously could work to the personal benefit of the person making the transfer and so on.

There are a number of reasons that I can think of that shareholders at least ought to have access to that information. And insofar as the link between officers and directors of the contributing corporation and directors of the nonprofit, it seems to me that is exactly the kind of information that shareholders are already entrusted with when it comes to other benefits to the directors and the officers of the company in which they invest.

For example, I think I would make the same argument that you just made about the value of getting your officers or your board members involved in a charity that you are contributing to when it comes to stock options. You know, we give officers and directors stock options all of the time. There is a potential conflict of interest there, of course, but for the most part I think companies and management believe, and generally investors go along with this, that giving people who work there a stake in the outcome is a good idea. Yet our disclosure rules require us to disclose the hell out of this area to make sure that there is not a conflict of interest. That didn't stop companies from—do you have stock options?

Mr. MASON. Yes, sir.

Mr. COX. You bet, and so do most corporate insiders. The fact that there is disclosure doesn't in any way chill the use. Why doesn't it chill the use of stock options?

Mr. MASON. Well, Mr. Cox, I am not certain where we are going on this. We offer stock options to a lot of men and women within my company, not just the senior officers.

Mr. COX. But specifically, why does the fact that you have to disclose the details as an insider transaction, as it were, not deter you from doing it?

Mr. MASON. It is a good point. We certainly do disclose that candidly in our proxy statement.

Mr. COX. By law?

Mr. MASON. By law, on an aggregated basis. There are certain individuals with their compensation that are outlined.

I think philanthropy and what we are talking about on stock options, although—I am not arguing with you. We chose to disclose. We choose to do that on a voluntary basis. I can understand some organizations not being particularly enamored with doing that, and I think you and I would know those types of organizations. I think if you can't stand the heat in this, you ought not to show your philanthropy.

We are not going to make a major difference with our corporate philanthropy in health and human services across this country of ours. We think that we are trying to do those things, Mr. Cox, on the margin that might make a difference.

Mr. COX. You want to do your part?

Mr. MASON. Yes, sir. And we would like to have those men and women who are employees of ours step up to that both from a volunteer standpoint, giving of their time and talent as well as some resources, as well as the company matching that activity. I think the centerpiece for our philanthropy has been our support of the United Way. For every dollar a man and woman who works for Eaton contributes, we put in 50 cents. And that doesn't sound like much until you start aggregating that pot and it is about $2.5 million that our employees give and we are doing about 50 percent of that. So aggregating, you are getting close to $4 million.

Mr. COX. I think it is going to be very hard for the four of us to disagree on most of these things because it is rather obvious that corporate contributions are made for the purpose of benefiting the general community of which business organizations find themselves a part. It is well understood that encouraging employees, management, directors, to participate in their communities is a good thing, makes them better workers, makes the community a better place. And it is all benign.

The very reason that corporations make charitable contributions is that they wish to show themselves to be good corporate citizens, and they wish to be good corporate citizens. For that very reason, many corporations go out of their way to advertise their charitable involvements. The disclosure of those charitable contributions would as a result only further advertise what they already are proud of and what they want to take credit for and encourage more of.

So what we are talking about here, if there is a chill at all, is chilling things that for some reason somebody that is part of the transaction would rather cover up, would rather keep a secret. And I wonder if I could ask, Mr. Thompson, what kinds of transactions are those?

Mr. THOMPSON. They are basically conflict-of-interest transactions. Your point about not many companies not disclosing stock options is a strong one. Probably a few more disclose their charitable contributions because of the benefit that you just described of being a good corporate citizen, but not many do.

The SEC study done at the request of the committee has a survey of the largest 100 corporations, and they tried to get the information from those companies about their charitable contributions and it was pretty hard to get the information. So there was some resistance to that. Where the resistance will be the most is where there is a specific conflict, a potential for embarrassment, and they don't want the embarrassment.

Mr. COX. Let us say that a company has a union and let us say that the company does not—at least its management does not wish to antagonize the union, but the company wants to influence legislation in Washington. Could the company make a contribution to a nonprofit organization which would then advertise against the union's position at arm's length and not disclose that to anybody?

Mr. THOMPSON. The line between charity and business expenses is sometimes gray and hard to define, and your example might well fall into that gray area.

Most of the stories and concerns which have been raised by charitable contributions have been more directly related to charity, but it would not exclude the example that you raised.

Mr. COX. Your concern is officers and directors using corporate assets to benefit themselves personally; is that what you think is the garden-variety abuse?

Mr. THOMPSON. They are given the right how to decide to use other people's money, and that is done for corporate purposes. That discretion is sometimes used for charitable contributions which can be good. But when they get a personal benefit from that, we have crossed the line from the beneficial use to the use that should concern us. This legislation tries to disclose those examples.

Mr. COX. I take it because the character of the personal benefit is always going to be in the eye of the beholder—these are subjective judgments—that you would recommend that Congress make no attempt to actually regulate corporate gifts themselves, but rather simply use the disclosure model to let the market handle it?

Mr. THOMPSON. Disclosure is the best police officer, and the market can decide for itself. I would expect that many corporations would present their charitable contributions the way that Mr. Mason has described what Eaton does; showing its commitment to volunteerism. But within that context, there will be the information for shareholders to evaluate whether or not directors are getting too close to the line.

Mr. COX. There is an unchallenged assumption here that it is the business of corporations in part to contribute money to their communities. There is another point of view. Milton Friedman once wrote, "Few trends could so thoroughly undermine the foundation of our society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible." Of course he fleshed out his reasons for saying that, and they are not trivial. We are not asking that question here this morning with the consideration of this bill because the bill essentially would state in law that this is an acceptable practice; but should we be concerned in any way at the margin about the license that this bill would give for corporate philanthropy which presently appears nowhere in the securities laws?

Mr. THOMPSON. For much of this century which is now closing, the law has not permitted those kinds of charitable contributions by corporations. It has been an evolution over the last few decades of this century to where that has been permissible. There is an argument against that which you have identified and addressed.

The Congress could if it wished take up that point. That is more likely a question for state corporate law than Federal securities laws. The reason that it is relevant for Federal securities laws is that disclosure is the main focus of Federal law and this bill picks up on that disclosure aspect and says disclose what you are doing within the bounds of State law.

Mr. COX. But you are the law professor and I am not. It is my understanding that there is nothing in the 1933 act or the 1934 act or the Investment Company Act today that in any way acknowledges that it is an appropriate mission of the corporation to give away money for no value?

Mr. THOMPSON. No.

Mr. COX. So this would be the first time that we are stating in statute that is okay?

Mr. THOMPSON. It is saying that if it happens, it needs to be disclosed.

Mr. COX. I don't think that you would task the SEC with the business of drafting regulations to determine at what threshold corporate contributions are being made if it were verboten.

Mr. THOMPSON. I think that is a fair statement, yes, sir.

Mr. COX. I just observe, Mr. Chairman, that ought to at least counterbalance, or more, concerns about chilling effects because this is the first time that Congress would be saying that this is an acceptable use of corporate funds and there are arguments that it is not.

I thank the chairman.

Mr. GILLMOR. Thank you very much, Mr. Cox. That will conclude our first panel and the hearing on H.R. 887. We will ask—I want to thank both of you, Mr. Thompson and Mr. Mason, for coming and helping us out.

We will ask our second panel to come forward.

Let us begin with opening statements. Congressman Markey who is a cosponsor of this bill, H.R. 1089, has made an opening statement.

Let me say that similar to mutual fund costs, most investors in nontax-deferred accounts do not understand how taxes impact total return, and most fund shareholders probably don't give much weight to tax considerations.

I would like to thank the chairman of the subcommittee, Chairman Oxley, and the ranking member, Ed Towns, for joining me in cosponsoring the legislation I have introduced, as has Mr. Markey.

This is an effort to provide millions of American shareholders relevant information regarding their financial objectives. I want to applaud the mutual fund industry for giving Americans an easy way to participate in American capitalism and for the enlightened view that they have by and large taken toward more disclosure of pre- and after-tax returns. If you look at the chart, you can see the impact that taxes have had on mutual fund returns. We have heard about the magic of compounding, but the magic of compounding doesn't discriminate. It works equally well with costs and taxes as it does with return.

The yellow bar shows a rate of return before taxes of the average mutual fund over the 15-year period ending June 30, 1998 and that was 13.6 percent.

The subcommittee held a hearing last fall on mutual fund fees and expenses, and the red bar represents the return of the average mutual fund after fees and expenses. And that is a return that is disclosed to fund shareholders. The majority of fund assets are in nontax-deferred accounts, and investors owe taxes on the distribution a fund makes.

The blue bar represents the total return shareholders get after they pay taxes, and based on the market return over a 15-year period, the average tax return or the average mutual fund represents only 67 percent of the pretax return that is disclosed to fund shareholders.

If the average annual return continues for another 5 years, a $10,000 initial investment in the market would have grown to $208,000. After costs and expenses, that $208,000 is reduced to $128,000. Finally, after taxes, the shareholder is left with just $75,000 or just 36 percent of the total market return. In other words, over 20 years the investor loses $133,000 to costs and taxes.

So after taxes, the rate of return for the average mutual fund fell to 10.8 percent. And at the end of the 15-year period, the after-tax return is only 69 percent of the pretax return.

It is clear that many mutual fund investors and managers focus only on investment performance before costs and taxes. As taxes are just an added cost to investors, fund shareholders should have an opportunity to judge a fund manager's trading activities to see how it impacts taxes.

Since we are talking here about taxes primarily derived from the stock market, here is what I think is an interesting figure. The Federal Government collected over $23 billion in taxes off mutual fund trading last year. Now if that were the only source of income for the U.S. Government, the United States would rank 150th on the Fortune 500 list based on revenues and we would be just ahead of Walt Disney and Coca-Cola.

Are some mutual fund income and capital gains distributions inevitable? Of course they are. Likewise, many are preventable as well. If minimizing taxable income is not important to the fund manager, it certainly is to the shareholder. A tax is a cost, and to the extent that taxes can represent as much or more than the cost of managing the mutual fund, I think investors should be provided this information in a form that is easily understood. Shareholders incur taxes when a fund makes income or capital gains distributions. When it sells securities, realizes a profit, capital gains are incurred and distributed, and the selling of those securities is a result of portfolio management decisions. And fund shareholders should be afforded the opportunity to review what the tax liability is that is going to be imposed on them.

Now, this bill does not in any way tell a fund manager when, what, or how frequently to buy or sell. It simply discloses the tax consequence of those actions.

I am encouraged by the efforts of the members of this panel and by the mutual fund industry to improve after-tax disclosure to shareholders. The Investment Company Institute has stated its support for the bill's objectives, and I am confident that we will continue to work together in the best interest of shareholders.

Our panel consists of Joel Dickson, Senior Investment Analyst of Vanguard Group; Mr. David Jones, Vice President, FMR Company, the Fidelity Mutual Fund Group; and Matthew Fink, the President of the Investment Company Institute, and we will begin with Mr. Dickson.

First, I want to ask Mr. Cox if he has an opening statement on this legislation.

Mr. COX. I do not. I am anxious to hear from the witnesses.

Mr. GILLMOR. You may proceed, Mr. Dickson.

STATEMENTS OF JOEL M. DICKSON, SENIOR INVESTMENT ANALYST, VANGUARD GROUP; DAVID B. JONES, VICE PRESIDENT, FMR CO.; AND MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. DICKSON. Thank you, Mr. Chairman and members of the subcommittee. I welcome the opportunity to testify today on the Mutual Fund Tax Awareness Act of 1999. The Vanguard Group strongly supports the bill's objective of providing better information on the actual return of mutual funds for taxable investors. To date, most investors have little or no idea about how taxes reduce their returns because the industry generally has not discussed the tax implications of mutual fund management.

Taxes are the largest cost of mutual fund investment for most investors. Based on calculations from Morningstar, the average domestic equity fund returned about 13.5 percent annually on a pretax basis over the last 10 years. However, these funds returned about 11 percent on an after-tax basis, a difference of 2.5 percentage points per year.

In fact, two funds with identical pretax returns can have very different after-tax returns. For example, a $10,000 investment in Vanguard Growth and Income Fund would have grown to about $47,700 over the last decade, about $1,000 more than in the Vanguard 500 Index Fund. However, on an after-tax basis, the index fund's total of $42,100 was some $4,600 higher. Vanguard has long encouraged investors to become more knowledgeable about the tax costs of investing. Most recently we began publishing after-tax mutual fund returns. We are the first mutual fund company to report after-tax returns for funds other than those that present themselves as tax managed. This is an important step because tax-managed funds represent less than 1 percent of industry assets. We believe that our new disclosure is in lockstep with the objectives of the bill being discussed today.

I would like to highlight one important aspect of our calculation. We calculate the return by accounting for the taxes paid on distributions made by the fund to its shareholders. The primary advantage of this approach is that it isolates the tax effects on all shareholders resulting from the portfolio manager's decisions.

An alternative would be to assume a shareholder sells his or her fund shares and pays all the taxes. Because this is an individual decision affecting a particular shareholder, it does not help investors understand how the manager's decisions affect performance. Vanguard believes that our calculation allows for a clear-cut discussion of after-tax returns without potentially confusing shareholders.

It is important to note that our after-tax calculation or any after-tax calculation for that matter, is not intended to represent the exact investment return for any particular investors. Every individual's return will differ based on his or her unique tax situation. Rather, our intent is to allow for relevant comparisons of tax effects across mutual funds with similar objectives.

Although certain assumptions must be made to compute an after-tax return, Vanguard believes that we have developed a presentation that gives relevant, useful information that the average investor can understand. Our annual report disclosure closes an important gap in the assessment of a fund's return and speaks directly to the goals of The Mutual Fund Tax Awareness Act of 1999. To the extent that others think that our methodology or presentation can be improved, we would welcome their input. Thank you very much.

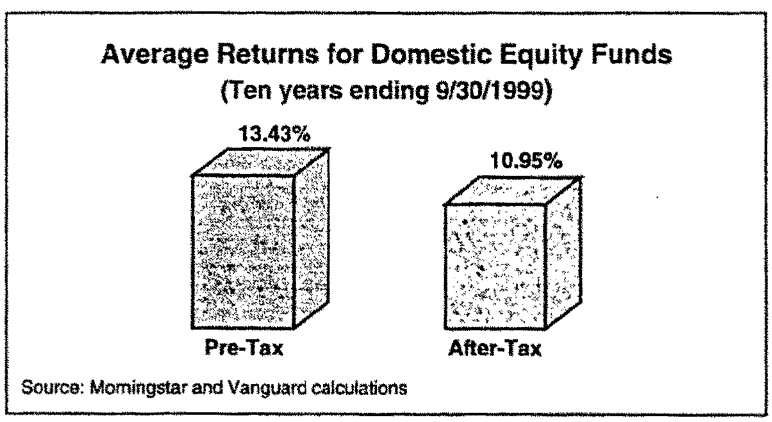
[The prepared statement of Joel M. Dickson follows:]

PREPARED STATEMENT OF JOEL M. DICKSON, PRINCIPAL, THE VANGUARD GROUP, INC.

I welcome the opportunity to testify today on the Mutual Fund Tax Awareness Act of 1999 and appreciate your invitation for me to address this topic. Vanguard strongly supports the bill's objective of providing to mutual fund shareholders better information on the actual return of their funds.

THE TAX COST OF MUTUAL FUND MANAGEMENT

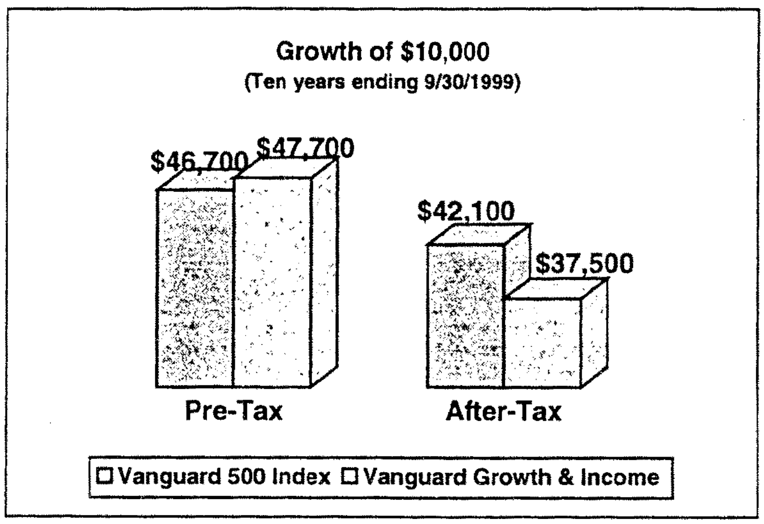
Taxes are the largest cost of mutual fund investment for most investors. Based on calculations using data from Morningstar, the average domestic equity mutual fund has lost nearly 2.5 percentage points per year to taxes on distributions of dividends and capital gains made to the fund's shareholders. Unfortunately, most investors have little or no idea about how taxes reduce their returns because the industry generally does not discuss the tax implications of mutual fund management.



If every fund lost the same amount to taxes each year, then little useful information would be gained by reporting after-tax returns. However, funds vary tremendously in the tax burdens they place on their shareholders. For this reason, pretax returns can be misleading for shareholders subject to taxes on the distributions they receive. Although the average annual tax bite was 2.5 percentage points, the amount lost to taxes for an individual fund ranged from zero (that is, the pretax and after-tax returns were equal) to 7.35 percentage points per year.

Rankings of funds' returns also differed greatly depending on whether pretax or after-tax returns are used. Of the 547 domestic equity funds with 10 years of returns, 118 (22%) would have their rankings change by more than 10 percentile points—i.e., they moved up or down by at least 55 spots in the rankings—depending on whether they were being evaluated on pretax or after-tax returns. The differences can be startling. The fund that lost the most to taxes each year ranked 28th on a pretax basis, yet fell to 272nd out of 547 funds on an after-tax basis.

Similarly, two funds that may appear identical on a pretax basis can have very different after-tax returns. As shown in the chart below, Vanguard Growth and Income Fund outperformed Vanguard 500 Index by a slight margin over the past ten years on a pretax basis. However, after considering taxes, the 500 Index Fund would have generated a substantially higher return. In other words, an investor in a tax-deferred vehicle—e.g., a 401(k) or Individual Retirement Arrangement—would have been better off with the Growth and Income Fund. The taxable investor, on the other hand, would have accumulated greater wealth with the 500 Index Fund.



Performance reporting that considers only pretax returns could lead taxable investors to believe that the past performance of a particular fund was much better than it actually was for a taxable shareholder. Because of these substantial differences in pretax and after-tax returns, we believe that after-tax returns should be reported in prospectuses or shareholder reports.

VANGUARD'S EFFORTS TO EDUCATE SHAREHOLDERS ON MUTUAL FUND TAXATION

Vanguard has long encouraged investors to become more knowledgeable about the tax costs of investing. Most recently, we began publishing after-tax returns in the annual reports of our equity and balanced mutual funds. In total, these initiatives represent a natural evolution of Vanguard's long-standing leadership position in providing clear and candid disclosure on issues that investors should understand when evaluating funds' performance. Some other examples of Vanguard's efforts to communicate the importance of taxes on mutual funds' returns include:

- developing a free, educational booklet, "Taxes and Mutual Funds," that describes the tax consequences of mutual fund investment;
- adding voluntary disclosure to our prospectuses regarding the portfolio manager's sensitivity to tax implications when making trading decisions. In most cases, our actively managed equity funds are managed for pretax return. In these cases, our prospectuses state that "this fund is generally not managed with respect to tax ramifications";
- launching five "tax-managed" funds that are offered only to taxable shareholders and publishing after-tax returns for these funds in the 1998 annual report to shareholders; and

- reporting estimated dividend and capital gain distributions well in advance of distribution dates so that shareholders can assess the impact of purchasing shares before the distribution, which might accelerate their tax liability.

VANGUARD'S INITIATIVE TO REPORT AFTER-TAX RETURNS

Earlier this month, Vanguard announced that we would start reporting after-tax returns in the annual reports of all of our balanced and equity mutual funds. Vanguard decided to publish after-tax returns for a broad range of funds after considering a number of options. Calculating and presenting after-tax returns raise a number of challenges, including what methodology to use and how to explain the returns to shareholders in a clear and concise manner. Ultimately, we believe that we succeeded in developing disclosure that meets the objectives of providing relevant, useful information that the average investor can understand. An example of our disclosure is presented on the following page.

A REPORT ON YOUR FUND'S AFTER-TAX RETURN

Beginning with this annual report, Vanguard is pleased to provide a review of the Equity Income Fund's after-tax performance. The figures on this page demonstrate the considerable impact that federal income taxes can have on a fund's return—an important consideration for investors who own mutual funds in taxable accounts. While the pretax return is most often used to tally a fund's performance, the fund's after-tax return, which accounts for taxes on distributions of capital gains and income dividends, is a better representation of the return that many investors actually received. *If you own the Equity Income Fund in a tax-deferred account such as an individual retirement account or a 401(k), this information does not apply to you. Such accounts are not subject to current taxes.*

The table below presents the pretax and after-tax returns for your fund and an appropriate peer group of mutual funds. Two things to keep in mind:

- The after-tax return calculations use the top federal income tax rates in effect at the time of each distribution. The tax burden, therefore, would be somewhat less, and the after-tax return somewhat more, for those in lower tax brackets.
- The peer funds' returns are provided by Morningstar, Inc. (Elsewhere in this report, returns for comparable mutual funds are based on data from Lipper Inc. and may differ somewhat.)

Average Annual Returns: Pretax and After-Tax
Periods Ended September 30, 1999

	1 Year		5 Years		10 Years	
	Pretax	After-Tax	Pretax	After-Tax	Pretax	After-Tax
Equity Income Fund	12.6%	10.4%	19.5%	17.2%	13.0%	10.7%
Average Large Value Fund*	15.9	13.9	17.5	14.6	13.2	10.5

*Based on data from Morningstar, Inc.

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As you can see, the Equity Income Fund's pretax total return of 12.6% for the 12 months ended September 30, 1999, was reduced by taxes to 10.4%. In other words, for investors in the highest tax bracket, the fund's pretax return was cut by 2.2 percentage points. In comparison, the average large-cap value fund earned a pretax return of 15.9% and an after-tax return of 13.9%, a difference of 2 percentage points.

Over longer periods, the Equity Income Fund's after-tax performance compares favorably with that of its average peer. Over the ten years ended September 30, 1999, your fund lost less to taxes (2.3 percentage points) than the peer-group average (2.7 percentage points) though it generated a slightly lower pretax return.

We must stress that because many interrelated factors affect how tax-friendly a fund may be, it's very difficult to predict tax efficiency. A fund's tax efficiency can be influenced by its turnover rate, the types of securities it holds, the accounting practices it uses when selling shares, and the net cash flow it receives.

Finally, it's important to understand that our calculation does not reflect the tax effect of your own investment activities. Specifically, you may incur additional capital gains taxes—thereby lowering your after-tax return—if you decide to sell all or some of your shares.

A Note About Our Calculations: Pretax total returns assume that all distributions received (income dividends, short-term capital gains, and long-term capital gains) are reinvested in new shares, while our after-tax returns assume that distributions are reduced by any taxes owed on them before reinvestment. When calculating the taxes due, we used the highest individual federal income tax rates at the time of the distributions. Those rates are currently 39.6% for dividends and short-term capital gains and 20% for long-term capital gains. State and local income taxes were not considered. The competitive group returns provided by Morningstar are calculated in a manner consistent with that used for Vanguard funds.

We believe our new disclosure is in lockstep with the objectives of the bill being discussed today, and I would like to highlight a few key points of our presentation. We made a conscious decision to publish after-tax returns in the annual reports only for balanced and equity funds and not for bond and money market funds. We view the annual report as the appropriate venue to discuss the impact of the investment adviser's decisions on investment returns. As previously documented, tax realizations vary greatly among equity funds because capital gain realizations resulting from the sale of stocks are largely at the discretion of the portfolio manager. On the other hand, there is little ability for bond fund managers to affect the relative after-tax returns of their funds because interest income received from a bond investment is not an event that can generally be controlled by the manager. Although we feel that a discussion of bond funds' after-tax returns does not warrant discussion in the annual reports, we do make these returns available through other media (e.g., over the phone or on our website) for shareholders seeking such information.

Overview of Vanguard's After-Tax Calculation Methodology

Our calculation of after-tax returns makes the following key assumptions:

- After-tax returns are calculated by reinvesting all of the fund's distributions made to shareholders, less any taxes owed on such distributions. (Pretax returns are computed by reinvesting the entire distribution.) In other words, taxes are owed at the time of the distribution.
- We use historical tax rates in the computations. Specifically, we use the highest individual federal income tax rates in effect at the time of the distribution (currently 39.6% for dividends and short-term capital gain distributions and 20% for long-term capital gain distributions). We make no adjustments for state or local income taxes.
- We assume that the fund shares were retained—not sold—at the end of the periods shown.

Pre-Liquidation vs. Post-Liquidation Returns

The most important assumption is that we assume no liquidation of the fund's shares at the end of the measurement period. This approach may understate the total taxes due for a shareholder who may ultimately redeem his or her investment and pay additional taxes upon such a sale. The primary advantage of the preliquidation figure is that it isolates the effects on all shareholders of the taxes resulting from the portfolio manager's investment decisions. That is, distribution of dividends and capital gains result from the fund's portfolio management activity and are given to *all shareholders* based on their pro-rata share of the fund's holdings.

An alternative methodology would be to assume a liquidation of the fund's shares at the end of the period, whether or not a shareholder would actually redeem his or her investment. In contrast to the preliquidation figure, this method tends to overstate the tax impact of mutual fund investments because it accelerates the tax liability for the buy-and-hold investor. More importantly, the sale of fund shares is an individual investment decision that results in a taxable event for a *particular shareholder.* It does not help investors understand how the manager's decisions affected the tax liability of all shareholders in the fund. Given these considerations, Vanguard believes that a pre-liquidation calculation is the best approach to assess how a manager's actions affect the after-tax returns received by shareholders.

Using the Highest Federal Marginal Tax Rates

By incorporating the highest individual federal income tax rate in effect at the time of the distribution, we are taking the most conservative approach by illustrating the greatest potential tax impact to total return. While this methodology will not incorporate the marginal tax brackets of all our taxable shareholders, it will ensure that the impact of taxes is not understated for an individual taxable investor. (We do not incorporate state and local taxes because of the significant complexity in calculation and presentation that would result in presenting returns for all 50 states and the District of Columbia.)

It is important to note that our after-tax calculation is not intended to represent the exact investment return for any particular investor because every individual's return will differ based on his or her unique tax situation. Rather, our intent is to allow for relevant comparisons of tax effects across mutual funds with similar objectives. Vanguard's methodology is the same used by Morningstar in their after-tax return calculations, which allows investors to make an "apples-to-apples" comparison between a Vanguard fund's after-tax returns and an appropriate peer-group average after-tax return.

That said, we realize that most shareholders do not fall within the highest federal marginal tax rate bracket—currently 39.6%. However, the difference between after-tax returns using the highest rate versus a more-common rate of 28% would be less than 0.4 percentage points annually for most of Vanguard's equity funds over the last ten years.[1]

Given this modest difference in returns, we decided to use the "highest rate" methodology because it is the most conservative approach and because it is much simpler to track the "highest rate" over time, rather than trying to determine what historical tax rates would correspond to today's tax brackets. We believe that it is extremely important to use historical tax rates in the calculation in order to capture any tax-related portfolio management decisions made as a result of anticipated tax rate changes.

SUMMARY

You will undoubtedly hear arguments that computing after-tax returns is a complicated endeavor that may lead to such confusion among investors that the information could do more harm than good. Although certain assumptions must be made to compute an after-tax return, we think these issues can be addressed without sacrificing either the relevance of the calculation or the clarity of the presentation. In fact, Vanguard has taken up this challenge, and we believe that we have developed clear, concise disclosure on the after-tax performance of our balanced and equity mutual funds. Our annual report disclosure closes an important gap in the assessment of a fund's return and speaks directly to the goals of the Mutual Fund Tax Awareness Act of 1999. To the extent that others think that our methodology or presentation can be improved, we would welcome their input.

Mr. GILLMOR. Thank you, Mr. Dickson.

Mr. Jones.

STATEMENT OF DAVID B. JONES

Mr. JONES. Thank you, Mr. Chairman and members of the subcommittee. I appreciate the opportunity to testify before you today regarding H.R. 1089, the Mutual Fund Tax Awareness Act of 1999. Fidelity Investments supports the bill's goal of providing investors with access to better after-tax return information for their funds. We believe investors would benefit from having a better understanding of the impact of taxes on their investments and from the development of an industry standard calculation which would allow relevant comparisons across different mutual funds.

We note in this respect that mutual funds as a group are relatively tax efficient investments compared to many other alternatives available to investors because in contrast to an investment such as a certificate of deposit or a Treasury bill which bears interest, mutual funds are allowed to provide investors with returns

[1] This relatively small difference in after-tax returns between the 28% and 39.6% tax rates occurs because the tax rate difference applies only to dividends and short-term capital gains. Over the past ten years, long-term capital gains have been taxed at the same rate (28% prior to the spring of 1997 and currently 20%) for all taxpayers outside of the lowest federal tax bracket. Among Vanguard's equity funds, long-term capital gains have generally represented the bulk of the taxable distributions.

taxable at more favorable long-term capital gain rates and not all of this necessarily is taxable in any given year.

Now, Fidelity first published after-tax returns for one of its funds in 1993, and we have developed an approach to calculating after-tax returns that we believe presents the impact of taxes fairly and accurately to investors. We have shared that approach with the SEC and have met with them on several occasions at their request to discuss some of the issues associated with this, and some of the very detailed matters of how the calculation works. But overall, the approach that we have developed is very similar to the approach developed by other industry members and analysts of the investment company community.

Nevertheless, there are some important details and differences that remain to be resolved.

Now any standardized return calculation does require a number of assumptions because investors have so many different tax positions individually. Possibly the most useful figure is to assume an individual investor in the highest tax bracket since that maximizes the tax impact, but inevitably this will be an inaccurate number for those investors in lower brackets, and importantly, for the very large number of investors who invest through retirement plans and are subject to completely different tax regimes.

After-tax returns also vary depending on whether you have presumed the investor continues to hold the account, so-called preliquidation return, or if you assume that the investor redeems their shares and uses the money for some purpose, a post-liquidation return.

Preliquidation returns will highlight the impact of dividends and distributions that an investor receives during the course of their holding period, but doesn't take all tax liabilities into account because some capital gain liability remains upon redemption.

As a result, preliquidation returns will tend to be higher. Post-liquidation returns are, after all, taxes, including anything due when the shares are redeemed, and including any exit fees that may be imposed by the fund company. This is consistent with the approach currently required by the SEC for pretax total returns. We feel that this gives a more realistic impression of tax impact for investors, particularly over longer time periods.

Now since 1993 our approach has been to show both of these numbers to investors because we believe that it is essential to see the two of them to truly understand the tax impact. Relative results can differ. A fund that appears to be have a superior return on a preliquidation basis may have an inferior return on a postliquidation basis, and vice versa. That is an important point. There are some examples of that in my written testimony.

So finally, I conclude by noting that the competing methods that we have of after-tax return calculation in the industry are very similar to each other, and this suggests that this forms a very sound basis for developing an industry standard. The next step is to hammer out some very important details and some philosophical questions ultimately to be arbitrated by the SEC so that we can have a consistent industry standard that is efficient for mutual fund companies to produce an effective tool for communicating to investors.

Thank you.
[The prepared statement of David B. Jones follows:]

PREPARED STATEMENT OF DAVID B. JONES, VICE PRESIDENT, FIDELITY MANAGEMENT & RESEARCH COMPANY

I. INTRODUCTION

My name is David B. Jones. I am Vice President of Fidelity Management & Research Company, the investment advisor to the Fidelity Investments group of mutual funds.[1]

I appreciate the opportunity to testify today on H.R. 1089, the "Mutual Fund Tax Awareness Act of 1999". This bill, which has been introduced by Representatives Gillmor, Markey and nine cosponsors, would direct the Securities and Exchange Commission ("SEC") to develop a requirement pursuant to which mutual funds would disclose the effects of taxes on returns to fund investors.

Fidelity Investments supports the bill's goals. We believe that investors would benefit from having access to after-tax return information for the funds they invest in; that the fund industry would benefit from having an industry-standard formula for after-tax returns, so that investors can compare funds on an equivalent basis; and that ultimately all would benefit from having better information available about the impact of taxes on fund returns. The mutual fund industry has built its success on providing investors with the education and the tools they need to invest responsibly. After-tax returns are one more tool that investors can use to gain a better understanding of the investment world and of their financial future.

In addition, we are mindful of the fact that mutual funds as a group are relatively tax-efficient investments compared to many other investment and savings alternatives. For example, savings accounts, certificates of deposit and even U.S. Treasury bills all generate returns that are 100% taxable, at ordinary income rates, in each year as the returns are earned. Mutual funds, by contrast, may generate returns that are wholly or partly taxable at more favorable long-term capital gain rates, and may allow investors to defer taxes on part of their returns until they liquidate (redeem) their investments. [2]

Fidelity Investments first published after-tax returns in 1993, in annual and semiannual reports for a Fidelity bond fund managed for after-tax results. Although that fund has since been liquidated, today we continue to publish after-tax returns for Fidelity Tax-Managed Stock Fund, which also is managed with after-tax results as an explicit goal.

In the years since 1993 we have developed a methodology for calculating after-tax returns that we believe fairly communicates the impact of taxes on a shareholder's investment. Other fund complexes, working independently, have developed competing methodologies, as has Morningstar, Inc. the well-known third-party analysis firm. While the methodologies developed by Fidelity, Morningstar and other firms are remarkably similar in many respects, important differences of opinion remain. There are still essential details and complex technical questions that will fall to the SEC to resolve.

Fidelity is prepared to do its part to help arrive at an industry standard for after-tax returns. We have met with the staff of the SEC on two occasions in 1999 to share our experiences on this subject, and have submitted to the staff, at their request, a letter outlining potential methodologies for calculating standardized after-tax returns for mutual funds.

The remainder of my testimony discusses aspects of the after-tax return calculation methodology that Fidelity employs. Some of the more detailed aspects of that

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[1] Fidelity Investments manages more than 280 funds with more than 15 million shareholders. With total assets under management of more than $833 billion, Fidelity is the largest mutual fund manager in the United States. Fidelity also makes more than 4,000 non-Fidelity funds available to investors through its FundsNetwork program.

[2] The tax benefits of mutual funds compared to other investments can be dramatic. An investor who bought our Fidelity OTC Portfolio on September 30, 1998 would have earned a 52.10% pretax return through September 30, 1999. After paying taxes on fund distributions, an individual investor in the top tax bracket would still have had a 48.86% return, which represents 94% of the pretax result. And after liquidating the investment and paying all remaining capital gains taxes (assuming long-term gain rates), the investor would have had an after-tax return of 40.87%, or 78% of the pretax return. (Source for returns: Morningstar Inc.) If that 52.10% return had been earned from another type of investment in the form of interest, the investor's after-tax return would have been 31.47%, or only 60% of the pretax result, because 39.6% of the return would have gone to pay federal taxes.

methodology, and some of the remaining open issues, are discussed in our letter to the SEC staff, a copy of which is attached as Exhibit 1.

II. MAJOR ASSUMPTIONS NEEDED TO CALCULATE AFTER-TAX RETURNS

After-tax returns are inherently more complicated than pre-tax returns, because each investor has a different tax situation. Some may be in high tax brackets and be very sensitive to taxes, while some may be in lower brackets and be relatively unconcerned. Some investors are not subject to individual tax rates at all: corporations, for example, or offshore investors. Most importantly, many investors buy shares through tax-deferred retirement plans, and will not be subject to any taxes on their investments until some time in the future. Tax-deferred retirement accounts represent more than 50% of most Fidelity funds' shareholder base by assets.

No one method can give the right after-tax result for all of these investors. As with any standardized calculation, inevitably the results will highlight one set of circumstances at the expense of others.

In providing after-tax returns for our tax-managed funds, we have chosen to calculate results for an individual investor in the highest marginal tax bracket. This choice implies several limitations: among other things, it will overstate the impact of taxes for many investors, because most are not in the highest tax bracket, and it will produce an inaccurate result for retirement investors, because they are subject to a different tax regime. However, this choice of tax rates is useful as a way of highlighting the impact of taxes for the most tax-sensitive investors.

Other assumptions and choices that must be made in developing a standard return include: whether to reflect state taxes (we do not), whether to use current tax rates or historical tax rates for historical periods (we prefer historical rates), when to assume that taxes are paid (we reflect them at the time that distributions are made, though others have suggested December 31 or April 15 of each year as an alternative), and how to handle special kinds of mutual fund distributions, such as returns of capital or distributions derived from real estate investment trusts. These assumptions will have a less material effect than the choice of a tax bracket, but they must still be resolved in a standard way for returns to be comparable across different funds.

III. PRE-LIQUIDATION AND POST-LIQUIDATION RETURNS

"Pre-liquidation" returns are adjusted for taxes resulting from fund distributions—dividends, capital gains distributions, and other payments that funds make to their shareholders. Pre-liquidation returns do not reflect any taxes that may be due when an investor redeems his or her investment. We sometimes describe them as "your after-tax return if you continued to hold your shares."

We quote pre-liquidation returns for our tax-managed fund because current income is of great concern to tax-sensitive investors, and pre-liquidation returns highlight this aspect of mutual funds best. But because pre-liquidation returns do not reflect the taxes due upon redeeming shares, they can give a false picture of the impact of taxes on mutual fund investments: they are "after-tax" in a sense, but not after *all* taxes.

At current federal tax rates, at least 20% of an investor's gains—the most favorable tax rate available to investors in the maximum bracket—will ultimately go to taxes (unless the investor dies before touching the money, or donates his or her shares before death). 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. As a result, we use them only in conjunction with "post-liquidation" returns, which reflect taxes due when the investment is reduced to cash that an investor can use. We sometimes describe post-liquidation returns as "your after-tax return if you closed your account."

Post-liquidation returns address other important disclosure concerns as well. Under current SEC requirements for pre-tax returns, funds must quote performance net of all exit fees or other charges (if any) that apply when a shareholder liquidates his or her investment. Pre-liquidation returns would not ordinarily reflect such charges, and thus could overstate performance. In addition, current SEC standards require funds to quote pre-tax returns for 1, 5 and 10-year holding periods. While a one-year period is relatively short, most mutual fund investors are likely to sell at least some of their shares before ten years are up, suggesting that a post-liquidation return may be the more relevant number.

For all these reasons, we feel compelled to quote post-liquidation returns as well as pre-liquidation returns, even though post-liquidation returns are normally lower numbers. However, this is a question on which reasonable parties may disagree, and it represents one of the areas where we expect further debate as the SEC decides on specific requirements.

IV. EXAMPLE OF AFTER-TAX RETURNS

To illustrate the impact of after-tax return calculations, the following table compares the returns of Fidelity OTC Portfolio, an aggressive, actively managed stock fund focused on the over-the-counter market, and Fidelity's Spartan U.S. Equity Index Fund, a fund managed to track the S&P 500 index, for periods ended September 30, 1999. The index fund has generally had lower taxable distributions, because of its less active management style. However, the relative after-tax result depends both on the time period chosen and on whether returns are viewed before or after liquidation (the higher result in each case is in **bold**)[3].

[In percent]

	Index Fund	OTC Fund
One-year results:		
Pretax	27.54	**52.10**
Pre-liquidation	26.87	**48.86**
Post-liquidation	21.74	**40.87**
Five-year results (annualized):		
Pretax	24.76	**25.40**
Pre-liquidation	**23.65**	22.30
Post-liquidation	**20.50**	20.08
Ten-year results (annualized):		
Pretax	16.51	**18.06**
Pre-liquidation	**15.26**	14.84
Post-liquidation	13.61	**13.75**

This example highlights the importance of considering both pre-liquidation and post-liquidation results when considering historical after-tax returns. The example demonstrates that after-tax returns tend to be lower than pre-tax returns, and that post-liquidation returns tend to be lower than pre-liquidation returns. The 5-year results exemplify how a fund may have a superior pre-tax performance but an inferior after-tax return. And the 10-year results show how a fund may have a return that appears superior when viewed on a pre-liquidation basis, but inferior when viewed in terms of post-liquidation results.

V. CONCLUSION

The mutual fund industry has a long history of working with its regulators in developing standards for disclosure to investors. When the SEC developed standard calculations for mutual fund yields and total returns in the 1980s, they received substantial input from the industry and others, and took this input into account in designing final rules. As a result of this thorough, detailed process, the standard calculations promulgated in the 1980s still work well today.

After-tax return calculations present a similar challenge. Industry members, working independently, have developed calculation methodologies that are similar in approach, suggesting that a standard calculation may be within reach. But important details remain to be resolved in order to assure that after-tax return calculations will be efficient for funds to produce and effective in communicating to investors. We look forward to working with other industry members and the SEC to develop effective standards.

Fidelity Investments appreciates the opportunity to testify before the Subcommittee. We support the objectives of the "Mutual Fund Awareness Act of 1999". We will continue to work with the Congress and the SEC in order to achieve after-tax measurements that will be most useful to our shareholders.

[3] Source: Morningstar Inc., assuming maximum individual tax rates. For these funds Morningstar's calculation methodology is essentially the same as that used by Fidelity currently, except that their one-year post-liquidation returns assume long-term rather than short-term capital gain tax rates apply.

EXHIBIT 1

4 August 1999

SUSAN NASH, *Esq., Senior Assistant Director*
Division of Investment Management
Securities and Exchange Commission
450 5th Street, N.W.
Washington, DC 20549

Re: Sample Calculation Methodology for Mutual Fund After-Tax Total Returns

DEAR MS. NASH: As you requested by phone, we have drafted a set of sample instructions for calculating mutual fund after-tax returns. The instructions are based on the calculation methodology we used in calculating after-tax returns for two of our funds that have tax management as an explicit investment goal: Spartan Bond Strategist, which operated from 1993 through 1996, and Fidelity Tax-Managed Stock Fund, which commenced operations in November 1998.

The sample instructions (enclosed) are designed to produce after-tax returns that would complement standard pre-tax returns calculated under Item 21(b)(1) of Form N-1A. As a result, they follow the same basic assumptions as those standard return calculations, including the assumption of a hypothetical $1,000 one-time initial investment and deduction of all sales loads and other charges, and assume that after-tax returns would be calculated on an annualized basis for 1-, 5- and 10-year periods. Similar tax adjustments could also be applied to other kinds of total returns (such as no-load returns, returns assuming a series of periodic investments, or returns for alternative time periods) with equal validity. As you requested, we have supplied instructions for pre-liquidation and post-liquidation after-tax returns.

As we have discussed, there is no one after-tax calculation that will be meaningful for all investors, because their tax situations can differ so dramatically. Therefore, we necessarily made a number of assumptions in calculating after-tax returns for our tax-managed funds, which are reflected in our sample instructions. They include the following:

1. *Individual Tax Rates.* We assumed tax rates for individuals, and assumed shares were held outside a tax-deferred account. A corporate investor, or an individual buying through a retirement plan, would have significantly different results: our calculation would not produce an after-tax return that would apply to them.

2. *Historical Tax Rates.* We believe that historical tax rates produce a more accurate result than current tax rates, although this method requires a rule for selecting historical tax brackets (we have supplied one possible rule, based on assuming a constant wage adjusted for inflation). We have not specified a particular tax bracket in the instructions; for our tax-managed funds, which were designed for higher-bracket investors, we used the maximum tax bracket, but this may be too high a rate for the more typical fund investor. We have also assumed deduction of federal taxes only, in order to produce a number that could be useful for investors in multiple states, and have not attempted to include the impact of the federal alternative minimum tax, which only applies to some taxpayers.

3. *Time of Deemed Tax Payment.* We have assumed that taxes on distributions are paid at the time of the distribution, as if they were withheld from the distributions before reinvestment. Although other methods could be imagined (redeeming shares from the account to pay taxes on December 31 or April 15, for example, or assuming taxes are paid from some separate cash account), we believe this method is the simplest and involves the fewest assumptions.

4. *Special Distribution Characteristics.* In addition to ordinary income dividends and capital gain distributions, funds may have distributions or other features with more complicated tax consequences. These may include distributions taxable as returns of capital, distributions that are partially derived from municipal interest and therefore are partially tax-free, distributions derived from REIT income (i.e., recaptured depreciation) taxable at a special 25% rate, distributions derived from commodities gains taxable at 28%, retained capital gains taxable at the fund level, and foreign tax credits or deductions that pass through with respect to foreign source income. Rather than enumerate how each of these should be handled in an after-tax return calculation, we have tried to describe more general principles under which these events would be taken into account based on their impact on an individual taxpayer.

5. *Gains or Losses on Redemption.* Taxes on capital gains are assumed to reduce ending value (and after-tax return), while losses on redemption are treated as a tax benefit that increases after-tax return. In effect, the calculation assumes that capital losses can be used to offset capital gains of the same character (long-term or short-term), giving rise to a benefit equal to the amount of taxes avoided as a result.

In addition, one essential simplifying assumption has been made: we recommend that shares acquired through reinvestment be treated as having the same holding period as the initial investment, so that gain or loss on shares reinvested in the last year could be treated as long-term rather than short-term. This greatly simplifies the recordkeeping required to calculate post-liquidation return, with only a minor impact on the result.

As you requested, our sample calculations do not include any provisions regarding whether the calculation methodology should be permissive (like a non-standard total return, which may be calculated many different ways) or mandatory (like a money market fund yield, which may only be calculated according to SEC guidelines). Nor do they address whether funds would be required to disclose after-tax returns in a specific document or permitted to disclose them according to a standard formula if desired. We note, however, that standardization is especially problematic where taxes are concerned, because investors are subject to such widely divergent tax regimes. And although the after-tax calculations we describe have worked well as voluntary disclosure for our tax-managed products in the past, we have never published after-tax returns for our other funds and do not have experience as to how other investors would react to them.

We appreciate the opportunity to assist the Division by describing our approach to after-tax returns, and look forward to additional discussions as your proposals progress. If you have any questions, please contact the undersigned at 617-563-6292 or Deborah Pege at 617-563-6379.

Sincerely yours,

DAVID B. JONES

cc: Craig S. Tyle, Investment Company Institute
Heidi Stam, The Vanguard Group

enclosure

METHODOLOGY FOR CALCULATION OF MUTUAL FUND AFTER-TAX RETURNS

FIDELITY MANAGEMENT & RESEARCH COMPANY DRAFT—AUGUST 4, 1999

A. *General.* After-tax returns should be calculated using the same assumptions and instructions as for average annual returns under Item 21(b)(1) of Form N-1A, with the exceptions noted below.

B. *After-Tax Return (Before Redemption).* For purposes of Instruction 2 to Item 21(b)(1), assume all taxable dividends or other distributions are reinvested after adjusting the distribution by an amount equal to the taxes applicable to the distribution. Do not assume complete redemption of shares as required by Instruction 4 to Item 21(b)(1).

C. *After-Tax Return (After Redemption).* Assume complete redemption as provided by Instruction 4 to Item 21(b)(1). In addition to the adjustments provided in Paragraph B above, adjust Ending Redeemable Value (ERV) by an amount equal to the capital gains taxes applicable to the redemption.

Instructions.

1. *Historical Tax Rates.* Use the federal tax rates applicable to individual taxpayers as of the historical date of each distribution or redemption. In determining the historical tax bracket applicable to each taxable transaction, assume the investor had a constant level of income (adjusted for inflation) over the period.

2. *Distributions.* Adjust each distribution before reinvestment by multiplying the amount of the distribution taxable at a given rate by one minus that rate. For example, adjust a distribution taxable as long-term capital gains by multiplying it by one minus the applicable tax rate for long-term capital gains.

   a. 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.

   b. In general, distributions should be adjusted to reflect the federal tax impact on an individual taxpayer. Distributions that would not be federally taxable to an individual (e.g., those taxable as tax-exempt interest or as returns of capital) should not be reduced before reinvestment.

3. *Redemption.* Adjust redemption proceeds by multiplying the capital gain or loss upon redemption by the applicable tax rate and subtracting the result from ERV.

a. Calculate capital gain or loss upon redemption by subtracting the total tax basis of the hypothetical $1,000 payment from the redemption proceeds (after deduction of any non-recurring charges as specified by Instruction 4 to Item 21(b)). State a capital gain as a positive number and a capital loss as a negative number, so that ERV will be adjusted downward in case of a capital gain and upward in case of a capital loss.

b. In calculating the total tax basis of the hypothetical $1,000 payment, include the cost basis attributable to reinvested distributions and any other costs basis adjustments that would apply to an individual investor.

c. When determining the character of capital gain or loss upon redemption, the fund may assume that shares acquired through reinvestment of distributions have the same holding period as the initial $1,000 investment.

Mr. GILLMOR. Thank you very much, Mr. Jones.

Mr. Fink.

STATEMENT OF MATTHEW P. FINK

Mr. FINK. Thank you very much, Mr. Chairman. I am pleased to say that the Investment Company Institute, the trade association for the mutual fund industry, strongly supports the bill's objective of improving disclosure to shareholders about the effect of taxes on mutual fund performance. As a witness on the previous panel on charitable contributions stated, disclosure has proved to be the best police officer in a lot of areas, and it certainly will be in this one. Mutual fund shareholders who have taxable accounts need to understand the important impact that taxes can have on their returns.

We have been discussing the relevant issues with both the bill's sponsors on this subcommittee and with the Securities and Exchange Commission. I have to say some of the issues are much more complex than it first appears on the surface, but I am hopeful that the SEC will come out with a proposal in the near future. We look forward to working with the SEC to resolve swiftly these various issues, and to get a final rule in place, as the prior witnesses said, to set an industry standard. Once there is a final rule, we hope that rule will meet the needs of investors, meet the expectations of the sponsors on this subcommittee, and I think it will enjoy the very strong support of the fund industry.

To name some of the issues that have to be resolved as a threshold matter, the SEC will have to decide whether it is best to expand upon existing disclosure requirements in prospectuses and annual reports, or to require funds to calculate one or more after-tax numbers as the other two witnesses have suggested.

If in fact an after-tax number is used, perhaps in a series of difficult computational issues, the most significant one is the one that the two witnesses before me highlighted: whether the return should simply be based on a preliquidation basis, which assumes that the investor receives dividends and capital gain distributions but holds his or her shares after the end of the period, or instead on a postliquidation basis, which assumes again that the investor receives distributions, but also that he or she redeems his or her shares at the end of the period.

As you just heard, there are different views in the industry, and this will be probably one of the most important issues the SEC will have to hammer out. There are other issues. Just to give you the obvious one that Mr. Jones just mentioned, which tax rate do we assume?

Both Vanguard and Fidelity have been urging using the highest taxable rate, which I think is 39.6 percent, but that applies only to a very small number of fund shareholders. Most are in far lower tax brackets, so you have an issue of which tax bracket to use.

But if I had to conclude with one final point, I want to emphasize how important it is going to be if an after-tax number or numbers are used. There has to be very careful textual disclosure of the inherent limitations in the numbers and of how one should look at them. Otherwise we could all easily inadvertently mislead investors.

Let me give three possible areas that we have to worry about. First, investors have to be told that after-tax returns will vary from investor to investor depending on their Federal tax rate and their State situation. And of course we have to make clear to the 50 percent of shareholders who are in tax-exempt accounts, IRAs, 401(k) plans, that none of this makes any difference to them.

Second, we have to again tell investors that while taxes are very important, as indicated by Mr. Gillmor's chart, taxes are only one important factor to consider. It is not the only factor.

And third, if I had to stress one point, and as Mr. Markey stated in his opening statement, it has to be made very clear to investors that these numbers are in no way predictive of what is going to happen in the future. You could very easily have a fund which has been very tax efficient in the past, and in the new year ahead of us it could have substantial taxable distributions, in part because the size, scale, and timing of the distributions often are out of the control of the portfolio manager of the fund. So we really have to warn investors that this is not predictive.

I am confident, based on working with people like those on this panel and with the SEC over the last 28 years, that all of this can be resolved in SEC rulemaking.

I would like to thank the chairman and the other members of the committee for their leadership in this area, and we are hopeful and confident that it will all soon be resolved. Thank you.

[The prepared statement of Matthew P. Fink follows:]

PREPARED STATEMENT OF MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

I. INTRODUCTION

My name is Matthew P. Fink. I am the President of the Investment Company Institute, the national association of the American investment company industry.[1]

I appreciate the opportunity to testify today on H.R. 1089, the "Mutual Fund Tax Awareness Act of 1999." This bill, introduced by Representatives Gillmor, Markey and nine co-sponsors, would direct the Securities and Exchange Commission ("SEC") to develop a rule to require mutual funds to disclose the effects of taxes on returns to fund investors.

The Institute thanks you for giving us the opportunity to work with you on this legislation. Ensuring that mutual fund investors understand the impact that taxes can have on returns generated in their taxable accounts is entirely consistent with the Institute's long-standing, strong support for initiatives to improve disclosure to investors.

The industry has taken several steps to promote the disclosure improvements sought by the legislation. Following the introduction last year of similar legislation, the Institute formed a task force of its members to develop approaches for identi-

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,729 open-end investment companies ("mutual funds"), 485 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.010 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

fying and resolving the complex issues associated with disclosing after-tax returns. The industry has had discussions with Mr. Gillmor, Mr. Markey, others of you, and the SEC regarding after-tax return disclosure issues. We submitted materials to the SEC in July regarding possible methodologies for calculating after-tax returns.

We understand that the SEC staff is actively considering this matter. The Institute is committed to working with the Congress and the SEC as this process moves forward toward completion.

The remainder of my testimony provides background on the tax aspects of investing in mutual funds, a summary of current disclosure requirements and finally a discussion of approaches to after-tax disclosure and issues raised by these approaches.

II. TAX ASPECTS OF MUTUAL FUND INVESTING

A mutual fund shareholder invested in a taxable account may be taxed on his investment in two ways: first, when the fund distributes its income and net realized gains (whether received in cash or reinvested in additional shares); second, when the investor redeems fund shares at a gain (whether received in cash or exchanged for shares in another fund).

A. Distributions to Shareholders

The timing and character of mutual fund distributions is governed by the Internal Revenue Code. The Code effectively requires a mutual fund to distribute all of the income and net gains from its portfolio investments annually. A fund's distributions may be taxable to the shareholder in two different ways: (1) as ordinary income (e.g., dividends, taxable interest and net short-term capital gains) or (2) as long-term capital gains (i.e., capital gain dividends attributable to net long-term capital gains). This is the case whether the shareholder takes his distributions or reinvests them. Distributions also may be exempt from tax (e.g., exempt-interest dividends attributable to tax-exempt interest).

The amount of mutual fund distributions can be affected by a fund's investment policies and strategies (e.g., depending on whether it has a policy of actively trading its portfolio) and by factors outside the control of the fund's investment adviser. For example, a fund that experiences net redemptions can be forced to sell portfolio securities to meet redemptions and thereby realize gains that it otherwise would not.

B. Redemptions by Shareholders

Redemptions (sales) of mutual fund shares result in taxable gain (or loss) to the redeeming investor (whether the proceeds are received in cash or exchanged for shares of another fund). This gain or loss is based upon the difference between what the investor paid for the shares (including the value of shares purchased with reinvested dividends) and the price at which he sold them.

All of a fund investor's economic return ultimately is received either as a distribution or as redemption gain. Consequently, there is a clear inverse relationship between these two tax consequences. If a fund makes relatively lower distributions because it does not realize its gains, gains build up in the fund. Consequently, a redeeming shareholder will have larger capital gains upon redemption than he otherwise would have had if the fund had realized and distributed the gains.[2]

C. Nontaxable Accounts

It is important to note that the tax impact discussed above is not applicable in the case of investors that hold their mutual fund shares in a tax-deferred account, such as a qualified employer-sponsored retirement plan (e.g., a 401(k) plan), or an Individual Retirement Account. As of year-end 1998, 45% of all mutual fund assets (other than money market funds), and 50% of all equity fund assets, were held in a tax-deferred account.[3]

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[2] For example, consider two funds (A & B) each of which has a $10.00 net asset value ("NAV") at the beginning of the measurement period and an $11.00 NAV at the end of the period (before distributions). The $1 increase in NAV represents a 10% return for the measurement period. Further assume that Fund A distributes $0.20 per share and Fund B distributes $0.40 per share on the last day of the measurement period. An investor in Fund A receives 20% of the return in the form of a $0.20 per-share taxable distribution, with the remaining 80% of the return presently untaxed in the form of an $0.80 increase from the original $10.00 NAV. An investor in Fund B, in contrast, receives 40% of the return in the form of a $0.40 per-share taxable distribution, with the remaining 60% of the return presently untaxed in the form of a $0.60 increase from the original $10.00 NAV.

[3] Source: ICI data used in publishing 1999 Mutual Fund Fact Book (39th ed.).

III. CURRENT DISCLOSURE REQUIREMENTS

The SEC currently requires that the general tax effect of investing in mutual funds be disclosed to investors in a plain English narrative in a fund's prospectus. Mutual funds are required to describe "the tax consequences to shareholders of buying, holding, exchanging and selling the Fund's shares," including, as applicable, specific disclosures that distributions from the fund may be taxed as ordinary income or capital gains, that distributions may be subject to tax whether they are received in cash or reinvested, and that exchanges for shares of another fund will be treated as a sale of the fund's shares and subject to tax.[4] Any fund that may engage in active and frequent trading of portfolio securities also is required to explain the tax consequences of increased portfolio turnover, and how this may affect the fund's performance.[5]

All funds are required to provide investors with other information that may reflect the tax consequences of investing, including the fund's portfolio turnover rate and the amount of its net unrealized gains.[6] The financial highlights table, which is required to be included in fund prospectuses and annual reports, also contains information on a fund's distributions, including distributions attributable to income and to realized gains.[7]

IV. ISSUES FOR SEC CONSIDERATION

The Institute agrees with the intent of H.R. 1089 and supports the approach taken under H.R. 1089, which leaves after-tax disclosure to SEC rulemaking. Development of this disclosure will require the consideration of several surprisingly complex issues, some of which may not be immediately apparent. Thus, this issue is a good candidate for the rulemaking notice and comment process, where especially complex issues can be resolved.

A. Improved Narrative Disclosure vs. Providing One or More After-Tax Return Numbers

A threshold matter that the SEC will have to consider is whether to expand upon the existing required disclosures, or to require funds to calculate one or more after-tax return numbers. On the one hand, an after-tax number might appear more straightforward, as it would not require a shareholder to review financial statements and apply the correct tax rates in order to determine the effects of taxes upon his return. In this way, it also might facilitate the ability of shareholders to compare different funds.

On the other hand, an after-tax number could have inherent limitations. As described more fully below, in order to compute an after-tax number, funds will have to make a series of assumptions, many of which may not be applicable to any particular shareholder. This runs the risk of inadvertently misleading investors. It also should be noted that other financial products, including ones that compete with mutual funds, are not required to disclose their after-tax returns and thus comparisons between competing products will not be possible.[8]

Assuming the SEC determines that it is appropriate to require funds to disclose an after-tax return number, two types of issues will have to be addressed. The first relates to the actual computation of after-tax return(s). The second relates to the need to ensure investor understanding of this information.

B. COMPUTATIONAL CONSIDERATIONS

1. After-Tax Calculations on a Pre-Liquidation and/or Post-Liquidation Basis—Perhaps the most significant computation issue is whether any after-tax return formula should assume that the investor continues to hold, or instead redeems, his shares at the end of the period for which the return is being calculated. If the formula assumes that he holds the shares (the "pre-liquidation calculation"), the after-

[4] See Item 7(e) of Form N-1A. There are also special disclosures required of tax-exempt funds.

[5] See Instruction 7 to Item 4(b)(1) of Form N-1A.

[6] Portfolio turnover rate is included in the fund's financial highlights table (see Item 9(a) of Form N-1A); net unrealized gains are reported in the fund's financial statements (see Rule 6-05 of Regulation S-X).

As was noted recently in Morningstar FundInvestor, however, a fund's portfolio turnover and potential capital gains exposure are at best only loosely correlated with the level of a fund's taxable distributions. See Morningstar FundInvestor, Vol. 8 No. 1, September 1999.

[7] See Item 9(a) of Form N-1A.

[8] The SEC may decide to require some funds, but not all, to disclose their after-tax returns. The SEC could either exempt some funds, such as money market funds or funds sold principally to tax-deferred accounts, or only apply the requirement to certain types of funds, such as funds that hold themselves out as "tax managed".

tax return would be calculated by reducing the fund's total return by the tax due on distributions made during the measurement period. If the formula assumes that he redeems the shares (the "post-liquidation calculation"), the return would be further adjusted to reflect capital gains (or possibly capital losses) that would be realized upon redemption.

The first (pre-liquidation) alternative is intended to disclose the tax effects only of actions taken by the fund, by reflecting the tax impact of distributions made by the fund during the measurement period(s). The second (post-liquidation) alternative, in contrast, also reflects the *potential* impact of taxes on (1) unrealized appreciation in the fund's portfolio and (2) realized but undistributed capital gains. It thus better discloses an investor's total potential tax exposure *but*, in order to do so, assumes that the investor will redeem his shares at the end of the measurement period, which will probably not be the case.

2. Federal and State Tax Rate Assumptions—Other significant issues involve the assumptions regarding applicable federal and state income tax rates to be used (or not used) in calculating after-tax returns. For example, which federal tax rate should be applied to income distributions? As a preliminary matter, the Institute believes that it may not be appropriate to apply the top federal tax rate (currently 39.6%) to fund distributions, since this rate currently applies to individuals with a taxable income of more than $283,150, while the median income of mutual fund shareholders is approximately $55,000.[9] Another issue is whether current or historical rates should be used. For example, if a fund were computing its 10-year after-tax return, should it apply the 1990 income tax rates to distributions made in 1990, or the present day rates? Finally, the SEC will have to consider whether other taxes, such as state tax, should be reflected; because of the complexity, the Institute believes that they should not.[10]

C. Ensuring Investor Understanding of the Information

The after-tax return numbers must be accompanied by disclosure that informs investors of their appropriate use and inherent limitations. Otherwise, investors could misunderstand them, and be inadvertently misled as to the impact of taxes on their returns.

1. After-Tax Returns Vary From Investor to Investor—It must be clearly disclosed to fund investors that after-tax returns will vary significantly from investor to investor (unlike pre-tax total returns, which are equally relevant for all investors in a fund for the measurement period).[11] Thus, any after-tax return disclosed by a fund may not, and probably *will* not, reflect a fund shareholder's own individual circumstances. There are as many after-tax returns for a given pre-tax return as there are possible combinations of potentially applicable federal and state tax rates. In addition, different investors in the same fund may be more or less tax-sensitive depending, for example, on an investor's ability to offset distributed capital gains against unrelated, realized losses. And, for some investors—such as those who hold fund shares in IRAs or 401(k) plans—after-tax returns will have no relevance.

2. After-Tax Return Numbers Are Not Predictive—There are "predictive" limitations to an after-tax return number. As noted above, the future behavior of some fund shareholders (*e.g.*, redemption activity) can have a significant impact on other shareholders' after-tax returns. In addition, "good" past after-tax returns could mean that the shareholder has *more* potential tax exposure in the future. If most of a fund's gains were unrealized, those gains could lead to greater distributions in the coming years.

Thus, the Institute would recommend inclusion of a cautionary legend, similar to that required for total pre-tax return data, disclosing that an after-tax return number reflects past tax effects and is not predictive of future tax effects.

3. Taxes Are One of Many Important Factors When Making Investment Decisions—While taxes are an important consideration for investors purchasing fund shares in their taxable accounts, other factors also are important. For example, investors purchase bond funds to receive current distributions of interest income, taxable at federal tax rates up to 39.6% (except in the case of municipal bond funds). A taxable investor's goal should be, consistent with his investment objectives, to maximize after-tax returns rather than to minimize taxes.

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[9] Source: ICI 1999 Mutual Fund Fact Book (39th ed.) 45.

[10] Other computational issues are noted in the attached Institute letter to the SEC.

[11] Under the SEC's methodology for calculating pre-tax total return, which assumes a hypothetical $1,000 investment and the reinvestment of all fund distributions, all investors in the fund throughout the measurement period will have the same return (provided they have the same account transactions—*e.g.*, all dividends are reinvested, no other share purchases occur and no shares are redeemed).

V. CONCLUSION

The Institute appreciates the opportunity to testify before the Subcommittee. We support the objectives of the "Mutual Fund Tax Awareness Act of 1999" to improve disclosure to investors of tax effects on mutual fund total returns. We will continue to work with the Congress and the SEC in order to achieve a result that will be most useful for our 77 million shareholders.

Mr. GILLMOR. Thank you very much, Mr. Fink.

I might say that I agree that it isn't as simple as it might first appear. You have the pre- and postredemption problem, and you have the problem that it is not going to treat all taxpayers the same, but it is a guide and information that they don't have now. In that sense I think we at least would have less confusion.

But let me ask you, Mr. Fink, or any other members of the panel, do you have any idea at this point how many of those thousands of mutual funds out there do some kind of after-tax disclosure?

Mr. FINK. I believe there are now 30 tax-managed funds that do that, and I think there are something like 200 index funds which probably also talk about the area.

Mr. DICKSON. In terms of actually disclosing an after-tax return, to my knowledge some tax-managed funds do it, the numbers that Mr. Fink cited. And to this point, Vanguard just recently announced that we will be doing it for 47 of our funds, and also providing the information. Although not in shareholder reports, for most of the remainder of our funds through Web site or over the phone.

Other than that, I am not aware of any widespread after-tax disclosure of returns within the industry.

Mr. GILLMOR. All of that is a very small percentage. I would guess that it is probably a significant improvement over 5 years ago, when I doubt if anybody did it.

Let me ask, Mr. Jones, Fidelity's after-tax returns of Fidelity's tax-managed fund, what is your evaluation of how shareholders have received and reviewed that information and have you given any thought of publishing those kind of returns on other equity funds?

Mr. JONES. The tax-managed fund shareholders that we have communicated this sort of return to have, I think, found it useful generally. I think I take it as a favorable reaction that we haven't had too many questions. One of our concerns early on was will people just say, "What the heck does this number mean?" But it seems it has been effective in communicating to the investors in that category who are interested in tax impact before they invest in the fund at all.

For our other funds we don't presently calculate the number. Like most fund groups, we have a lot of information on tax impact available but most of it is narrative or it is information like how much distributions have been paid. It isn't pulled together to a return number. Looking at the future, I think regardless almost of action by the Securities and Exchange Commission, I think customer demand will require us to make that information available on more funds.

Mr. GILLMOR. It would seem to me because of the different ways this can be disclosed, one of the advantages of the legislation is that we get a uniform disclosure so that shareholders can really be comparing apples and apples. I will yield back.

Mr. Markey?

Mr. MARKEY. Thank you, Mr. Chairman, very much. This is a very interesting chart that is up in the room today. The numbers we have before them, that would probably surprise a lot of investors to see the huge differential that exists between what they might see in the newspaper and then what ultimately winds up going to them and the role which taxes plays in reducing that total.

I think what Mr. Gillmor and I have as our intent is just that the investor can see this, understand it, and then make marketplace judgments. And the logical differential, of course, is the greater the likelihood that an investor will move over to another fund.

My entire investment is relatively modest in a Fidelity Spartan Index 500 Fund, and while the fees are slightly higher, almost infinitesimally higher than Vanguard, Fidelity is in Boston so I stick with Fidelity. They are the hometown team. But if combined with the tax management, combined with other things, the number just kept getting larger and larger, then I think there would be some reason to reconsider and it is just, I think, a matter of information that will ultimately determine the extent to which people are loyal for secondary considerations and how much the primary considerations are just overwhelming.

And that is what I think we are trying to achieve here. So for all of you, I understand that the average portfolio turnover rate for an actively managed non-index mutual fund has increased from 30 percent 20 years ago to 90 percent today, managers who turn over their portfolios without considering the tax consequences of their decisions on fund investors might sell stocks in which the fund has made short-term gains, and other long-term gains without offsets, resulting in higher yearly taxes for investors.

Again, you do agree, according to your testimony, that the investors should get the right to the disclosure of the tax-adjusted performance for that fund. Do you agree with that? Both of you?

Mr. DICKSON. That's correct.

Mr. JONES. Yes.

Mr. MARKEY. Mr. Fink, you indicated that one of the key issues for the FCC to make is a decision in the rulemaking mandated by the Gillmor-Markey bill which would be to determine what type of after-tax number should be disclosed. The two options you mention are, No. 1, a preliquidation after-tax return and two, a postliquidation after-tax return. Does the ICI have a position at this time as to which of these two options is preferable?

Mr. FINK. No, particularly because I have my two biggest members sitting next to me who disagree on this. It has been talked about with other members but I think it really shows why you need—not to dodge the question—you really need an SEC public hearing to hear not only from people in the industry but the consumer groups, the Consumer Federation, the Association of Individual Investors. There are very good arguments for both. And I think you really need a public hearing and an open dialog, and I personally do not have a view at this point.

Mr. MARKEY. Thank you, Mr. Fink, for setting up the discussion. I appreciate it. So, Mr. Dickson, your firm, Vanguard, has recently begun disclosing after-tax returns. And I see from your testimony that you favor disclosure of preliquidation returns. Can you tell us why and why it is preferable to postliquidation?

Mr. DICKSON. Sure. There are a number of considerations. First of all let me say, and I certainly think I share this view with Mr. Jones, that we see value in both numbers. It is a question of presentation and a question of what is in the best interest to convey the information that we are trying to make. In the case of Vanguard and our decision to make preliquidation returns available through shareholder reports, we feel that the shareholder report talks about the actions of the portfolio manager that affect all shareholders in the fund. That is, the distributions of dividends and capital gains that are given to all shareholders in the fund. That is a preliquidation calculation.

It is certainly the case, and we have disclosure to this effect in our presentation, that additional taxes may be owed if you sell the fund's shares. However, just from one sort of level, annual reports only go to shareholders that are currently in the funds, so if you sell your fund's shares, you are not getting an annual report. Second, we do feel this is important information, but we feel it doesn't rise to the level of disclosure in the annual report. Instead, we would plan to make it available through other vehicles that are customized ways of showing an individual shareholder return, like through the Web or over the phone, where people can input, especially over the Web, different tax rates, different tax treatments, to be able to calculate their specific tax-adjusted return. For that level. To keep the clarity brief and to not overwhelm shareholders with a whole slew of different numbers for different time periods and different methodologies, we chose the preliquidation return as the best approach.

Mr. MARKEY. Mr. Jones, Fidelity favors postliquidation returns. Could you explain from your perspective the case for that kind of disclosure as opposed to the Vanguard preliquidation approach?

Mr. JONES. Absolutely. Just to clarify, our preference of what we have done in calculating and presenting these figures in the past has not been to show postliquidation only. It has been to show preliquidation and postliquidation. So the differences between Vanguard's approach and ours are actually perhaps smaller than they might appear. It is truly best seen as the difference between showing a preliquidation return and putting in the footnote, "postliquidation returns may be lower," which is more or less the Vanguard approach, noting that there may be other taxes due. Or, what we feel is necessary, saying preliquidation return is X, the postliquidation return is Y, and actually giving the actual amount of the difference.

Now, I think we felt that that is necessary in part to make sure that all taxes are taken into account so that you have a truly after-tax number and to make sure that any exit fees or other charges are taken into account as currently required by other SEC regulations.

Mr. MARKEY. But in your testimony, just so I can focus in on this pre- and post- issue, whichever one is going to lead, in other words, and then have the footnote after the lead number—what Mr. Dickson is saying in his testimony is that disclosing postliquidation tax-adjusted returns hinges the disclosure to the investor's decision to sell the fund rather than the fund manager's skill of performance in taking account of the tax consequences of the manager's buy or sell decisions. What is your response to that argument?

Mr. JONES. I would say it is true that the preliquidation and postliquidation returns are both based on a hypothetical investor. Both of them are hypothetical numbers saying let's assume that $1,000 is put into a fund at a given time, whether it is pre- or after-tax, in fact. The charges applicable to an account of that size are taken into account and then in the case of a preliquidation return, there is an assumption that the investor hasn't sold any shares and so there is an embedded tax liability that is unpaid. In postliquidation, there is an assumption that the investor did liquidate his or her shares. We feel that is a perfectly reasonable assumption, especially given the fact that standardized returns are required for periods up to 10 years. A tax-sensitive investor isn't really likely to trade out of their fund in 1 year if they are at a gain because they are a tax-sensitive investor and they would probably be reluctant to take a short-term gain. But quite a few investors in mutual funds, although we would like them to stay with us indefinitely, would have sold some of their shares by the time 10 years is up.

Mr. MARKEY. And, Mr. Dickson, Mr. Jones' testimony suggests that failing to disclose postliquidation returns gives a false picture of the impact of taxes on mutual fund investors because they foster the impression that taxes can be deferred indefinitely, when in fact they can't. How do you respond to that?

Mr. DICKSON. I completely agree with that approach. It is a question of whether—and, in fact, we address that in our disclosure by saying that in fact you may very well owe additional taxes at the time that you sell your fund shares. We just don't want to deem that redemption on the shareholder, which is a shareholder-specific action as opposed to a portfolio management action, and that deeming of redemption may or may not have actually occurred by the shareholder.

Certainly there is some unrealized potential tax liability, but to a certain extent you could even construct situations where you do get out of that tax liability the postliquidation scenario if the mutual fund shares passed through an estate or are given away as a charitable contribution. So it is really focusing on what the manager is effecting in terms of the performance for all shareholders in the fund as opposed to any particular shareholder.

Mr. MARKEY. Thank you, Mr. Dickson. I thank you, Mr. Chairman, for the extra time. Thank you.

Mr. GILLMOR. Before I go to Mr. Cox, I just thought of an advantage for this bill that I hadn't before and I don't know if Mr. Markey will agree with this result, but the more that people know—there are half the families in the country that own stock—how much their taxes are, we might get a lot more support for tax cuts here.

Mr. Cox.

Mr. COX. That is very true.

Mr. Dickson, you mentioned something a moment ago that I think this whole discussion is pregnant with, and the Web, and what your firm might do with it. I wonder if I could ask you what you consider the SEC might do with it, specifically? Should we imagine a future in which you all provide standardized inputs to the SEC, they put a calculator up on the Web as a potential investor and answer a few simple questions on the SEC's Web site, such as whether I have got any offsetting capital losses myself, what my tax bracket is and what State I live in, and let it rip?

Mr. DICKSON. Certainly that is possible. We view it—and certainly the SEC has actually done quite a nice service with putting up a cost comparison calculator on their Web site. However, at the end of the day, Vanguard wants to serve Vanguard shareholders, and to the extent there is a standardized calculation which this bill would address, then we can get those same results from doing individualized work on our own Web site as opposed to sending everything to the SEC.

Mr. COX. So the advantage would be simply that we would have the same measures, the same calculator across the industry rather than boutique calculator here and there and all slightly different?

Mr. DICKSON. Well, the one thing that I would say is there is certainly a lot more information that you might be able to pull of shareholders than just some specific items that you would send, as you were saying. You might be able to customize it based on information that only—that Vanguard might have for its shareholders or that the shareholder might have when logging on. We would just view—in terms of the presentation ourselves, we would love to do it and in fact we are planning to do it, to provide customized after-tax return calculations for shareholders on our Web site.

Mr. COX. I am not sure whether you think it would be appropriate for the SEC to do this.

Mr. DICKSON. I would say we would prefer to do it ourselves.

Mr. COX. Do our other witnesses have a view?

Mr. JONES. I think there are commercial services at present that are in the business of providing hypothetical performance information on a pretax basis. The data collection involved is actually fairly significant as is the data maintenance. It would be a new role for the SEC to move into that business and say that they will provide hypothetical return calculations. I think it is a question for gentlemen like yourselves as to whether that is an appropriate role. I would expect the same sort of third-party hypothetical performance providers would adopt an after-tax calculation, as they have in the past with other standard return calculations, once they have been standardized by the SEC.

Mr. COX. Having heard what your members think, Mr. Fink, what do you think?

Mr. FINK. I would guess that they wouldn't see anything wrong with the SEC doing it, but I think they would say better to have the marketplace do it; and given all the SEC's other responsibilities, they probably would say have individual firms do it. That is why I think the industry would come out.

Mr. Cox, I have an add-on which may sound disconnective but I want to make the point we are talking to two fund groups that sell directly to consumers basically. That is almost their entire business. That is a minority. Eighty percent of fund investors buy through third parties. Now, some of them may use the Web, but their biggest inclination is probably go to their broker, financial planner, bank, or employer because they are buying through third parties. It just changes when you look at the industry where people get information from. Their shareholders would go to them. If you are investing in the other 80 percent, you probably would not go to the web site of your fund. You would go——

Mr. COX. If I am buying through a broker, my broker could do it.

Mr. FINK. I'm sorry?

Mr. COX. I am sorry, too. I am a little hoarse today. If I am buying through a broker, my broker could use the SEC site?

Mr. FINK. Yes.

Mr. COX. It amounts to the same thing?

Mr. FINK. Yes.

Mr. COX. I have to say I'm a little bit surprised to hear a discussion about whether we should be doing pre- or postliquidation returns. Why in the world would we do both? Mutual funds are supposed to be liquid assets and therefore the idea of liquidating them shouldn't come as a shock. It is the very purpose that one would put funds there as opposed to something less liquid, and I think you ought to be able to get both answers.

In this era of cheap computing, it is not a great deal of trouble. It is amazingly routinized. Once you have got the information, the computer can crank out that data all day long and customize it for every individual investor at essentially zero cost. I think the greater concern here is all the assumptions that have to be made that haven't anything to do with the complexities of tax law but, rather, there is a built-in major league assumption up front that the past is prologue, as Shakespeare would put it, that these are in any way predictive measures.

And yet because we haven't anything else to go by, I think we all sort of swallow hard and look at what happened in the past and make our best guess about the future. We are also assuming that the taxpayer's current situation, which is all the taxpayer knows, is going to be the taxpayer's situation in the future. So you have got a double probabilistic variable here, that you not only need to concern yourself with whether the fund is going to be the same as the fund was in the past, but whether you and your tax situation are the same in the future. Then you have got us to worry about up here. Is Congress going to keep the same tax laws in place in the future that we have had in the past, and we haven't had any discussion whatsoever about States, but of course that is another layer of uncertainty. And in all of these sorts of things are what the market can do.

That is why we despair, ourselves, of trying to provide direction or guidance to investors on these funds and rather say, "Here is the information, you do with it what you will." What we are talking about here today is simply getting them the basic information that they can then evaluate and put in the Cuisinart with all these variables and uncertainties. I would hope we would strive to put as much hard data that we know is available in front of people rather than keep that back, because even once you have all the hard data, you are still out there in the middle of guess land. Otherwise, we would all be wealthy.

Mr. GILLMOR. Thank you very much, Mr. Cox. I want to thank the members of our panel and also the previous panel.

Mr. MARKEY. Mr. Chairman?

Mr. GILLMOR. Yes, Mr. Markey.

Mr. MARKEY. I thank you very much. First of all, I would like to follow up on Mr. Cox's line of questioning which I think focuses on the issue of whether or not the compromise between the two positions might not be disclosure of both, which is I think very much an interesting—again, something we can't determine, but I think that is an interesting approach that has to be considered, given the technological capacity of the SEC or any of these firms.

And I would also like to endorse the proposal by the gentleman from California that the SEC's Web site put data up mainly because, to be honest with you, that Web site would be subject to the Privacy Act which governs the retransfer of any of the information, and as a result people are going to be putting all of their financial data into a formula which would be on-line and in the hands of some private-sector company that would not be secure under our laws. Even the financial services modernization bill we are passing right now provides no privacy protection if the information is in the hands of the financial institution. So if we were going to do it and the individual wanted to use this type of a service but didn't want to disclose their entire tax position to Vanguard or Fidelity, using the SEC under the Privacy Act would probably be a good alternative.

Mr. COX. If the gentleman would yield, I think it is very important. People do feel a little bit more comfortable with the SEC than they do with some firms, not all of them, Vanguard and Fidelity, that they have never met before. On the other hand, I note that there is a subset of the population that probably feels a lot more comfortable providing their actual tax information to a private firm than they would to the U.S. Government.

Mr. MARKEY. I agree with that. The reality is that the SEC is probably the most respected agency in the Federal Government. They are in fact viewed as the cop on the beat, the guardian of the investor. The greatness of this industry, of course, is that they come to us with the most impeccable record of any part of the financial services community and that is to the credit of the mutual fund industry that they have been so willing to accept the kinds of regulations that we are even talking about today to ensure the investor is king.

So hopefully, as a result of legislation, we will be able to move it forward quickly, pass it in the House, have some response for the Senate, so that perhaps by the end of next year investors across this country could have this kind of information available to them before they are making their end of year 2000 decisions as to how they want to handle their investment portfolio.

I thank each of you for your excellent testimony. I yield back.

Mr. GILLMOR. Thank you very much. We stand adjourned.

[Whereupon, at 11:27 a.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

ASSOCIATION OF PUBLICLY TRADED COMPANIES
October 28, 1999

The Honorable TOM BLILEY
Chairman, Committee on Commerce
2125 Rayburn House Office Building
Washington, DC 20515-6115

The Honorable MICHAEL G. OXLEY
Chairman, Subcommittee on Finance and Hazardous Materials
2125 Rayburn House Office Building
Washington, DC 20515-6115

RE: Hearing on H.R. 887, Charitable Contributions Disclosure

DEAR CHAIRMAN BLILEY AND CHAIRMAN OXLEY: I am writing on behalf of the Board of Directors of the Association of Publicly Traded Companies to express our opposition to HR 887. While we have great respect for the sponsors of the legislation, we believe that new government regulation of this type will be counterproductive. I request that this letter be included in the record of the hearing.

INTRODUCTION

The Association of Publicly Traded Companies ("APTC") represents a wide range of public companies from the newest and smallest to larger, more established firms. Many of the Association's member companies are in the high-growth sector of the nation's economy. Our members are from the every American industry, representing the breadth and diversity of the entire economy. Moreover, our members develop the products and services upon which America's long-term economic health depends. As SEC registered public companies, all of our members would be required to make the new disclosures that are contemplated in H.R. 887. For all of these reasons, APTC believes that our comments deserve careful consideration.

THE ASSOCIATION'S POSITION IN OPPOSITION TO H.R. 887

Public companies are eager to communicate with investors on critical issues. In order to understand their investments, shareholders need the right kind of information about the company—audited financial statements, description of the business and the stated vision of the managers—in a clear concise document. APTC is concerned that too much of the information currently mandated by the SEC, especially in the proxy statement, distracts shareholders from the core questions of sound investing. H.R. 887 would add more distracting information to the proxy.

Moreover, H.R. 887, if enacted, would continue a disturbing trend toward more and more mandatory disclosure of non-material information. Investors should receive information that is *material to investment decisions.* Once this "materiality" rule gives way to a "for what it's worth" rule, the scope of natural curiosity is the only limit.

There is no need for the new disclosures that H.R. 887 would mandate.

We are mindful of Justice Louis Brandeis' famous admonition that "[s]unlight is said to be the best of disinfectant . . ." However, it is not clear that corporate philanthropy needs disinfecting. We see no evidence of corporate charitable profligacy. Nor are corporate directors sacrificing their integrity and violating their fiduciary duties in exchange for contributions to their favorite charities.

Requiring charitable contribution disclosure in the proxy will be counterproductive.

Governmentally mandated disclosure about extraneous matters distracts investors from material information about the company. Specific information about charitable contribution will send a confusing and erroneous message, i.e., "the SEC, your investor advocate, thinks that this information is important to you as an investor." The limited time that the investor has to study the potential long-term performance of the company may well be squandered pondering the significance of the company's charitable contributions.

Unfortunately, the annual proxy materials are already replete with information of marginal significance to the long-term performance of the company. In fact, proxy statements are dominated by mandatory information about executive and board compensation. More information regarding charitable contributions and their supposed links to officers and directors will serve to further clutter the proxy statement

The main consequence of the new disclosure will be the unintended ones.

The mandatory disclosure of charitable contributions could have negative, unintended consequence for both publicly traded companies and the charities and other non-profit organizations they support.

The only contributions a company ought to make are those that benefit the business. While a relationship between an officer or director and the charity may exist, the reasons for any given contribution are usually many and varied. It is the legal duty of the managers and the board to insure that the corporate assets are not wasted. This requirement provides adequate safeguards.

If all contributions must be disclosed, a new rule will likely be heard in many companies: "you can't get in trouble for contributions you don't make." Mandatory disclosure of contributions will lead to the need to justify those contributions and the requirement to be able to defend those contributions. In those circumstances, a corporation may conclude that it is prudent to simply avoid making contributions where the recipient has any relationship to an officer or director. That course may be a disservice to the charity, and to the officers and directors. But it may be the prudent course.

CONCLUSION

For the reasons stated here, the Association opposes H.R. 887. We are very interested in the issues raised by the legislation. We would be pleased to provide more information should the Committee pursue this matter further.

Very Truly Yours,

BRIAN T. BORDERS
President

cc: Brent Delmonte
Committee Counsel
Committee on Commerce
Washington, DC 20515-6115

THE BUSINESS ROUNDTABLE
July 23, 1999

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington D. D., 20509
Attn: Brian J. Lane, Director, Division of Corporate Finance

Re: Proposed Disclosure of Charitable Contributions (HR 887)

LADIES AND GENTLEMEN: Thank you for the opportunity to address the proposed Bill introduced in the House of Representatives (HR 887), which would require disclosure of charitable contributions by issuers that have securities registered under Section 12 of the Securities Exchange Act of 1934, as amended. The Business Roundtable (BRT) includes the CEOs of many of the country's largest corporations, virtually all of which are significant contributors to the arts, civic projects, charities and other worthwhile organizations and activities. Virtually all of the BRT members and senior executives of many other major U.S. companies are actively involved in charitable activities and, consequently, any legislation or regulations impacting such activities are of concern to the BRT.

The BRT believes the proposed requirement of disclosure of charitable contributions is unnecessary. For the reasons set forth in this letter, we believe the proposed disclosure is unnecessary for the protection of investors and is, at best, overbearing and unnecessarily burdensome. Many of the companies whose CEOs are members of the BRT already voluntarily make available reports of their charitable contributions to interested stockholders, and there has been no showing that there exists any abuse of corporate-giving programs to warrant the increased burden associated with the proposed legislative change. Moreover, if the Securities and Exchange Commission ("Commission") were to determine that such disclosure was necessary, it has ample authority to require it without legislative or regulatory changes.

1. *There is no justification for the proposed disclosure requirement.*

While some stockholders may have a special interest in knowing to which charities contributions have been made, no concern of general interest and materiality to stockholders is raised unless the contributions are so disproportionately large to the size of the reporting company as to amount to corporate waste or would otherwise reach the level where a director can be said to have failed to exercise his or her fiduciary duties. Under state corporate law, companies and their directors have a fiduciary duty to stockholders not to waste corporate assets. The decisions of a corporation on its community relations and charitable giving programs are quintessential business decisions, and under state law are within the purview to the board of directors and management. They involve considerations unique to each corporation, and its customer base and the communities in which it operates. Such decisions should not be made based on SEC disclosure policy or general stockholder referenda, but should be regulated pursuant to state law corporate governance standards. Further, state law provides sufficient ability for stockholders to regulate charitable "gifts" by their companies through their right to review the books and records of the company and their ability to present and advocate stockholder resolutions addressing such activities. SEC-mandated disclosure, as proposed, regarding charitable contributions would be tantamount to substituting federal legislation for a matter that is properly one for state law.

2. *Contributions to charitable organizations should be disclosed only if there is a significant direct or indirect economic benefit to an insider and the amount of the contribution is unusually large.*

The proposed legislation would require disclosure in proxy statements and other consent solicitation documents of charitable contributions in excess of an amount to be determined by the SEC if a director, officer or controlling person of the donor company, or their spouse serves as a director or trustee of the charity. While, for the reasons stated above, we think a general disclosure requirement for charitable contributions is both bad policy and an unwarranted intrusion on areas regulated by state corporate governance laws, there may be a limited number of instances where disclosure may be appropriate. We believe that if proxy disclosure is required, it should only be required if an insider serves as a director or trustee of the charity and there would be a significant direct economic benefit to the insider. For example, a substantial donation to a "private foundation" controlled by the insiders would generally be disclosable under the above described standard. This disclosure would be appropriate because the insider would have discretionary power over the donated funds after the donation. Similarly, a grant to a research institution or university for the development of bio-tech products would be disclosable if the company had a technology development agreement with the university and a director of the company received research funds from such contribution. The standard proposed for proxy disclosure by the proposed legislation seems to imply that disclosure under all circumstances is warranted because the insider is perceived as having received a benefit as a result of, or in connection with, the company's charitable donation. When the insider is not receiving any significant direct economic benefit from the contribution, no disclosure should be required. Under all circumstances, the threshold amount of contribution to a charity before disclosure is required should be substantial. No disclosure should be required if the aggregate amount of a company contributions does not exceed 2.5% of consolidated revenues.

3. *The proposed disclosure standards are unnecessarily complicated.*

As proposed, the bill distinguishes between proxy disclosure, and information regarding charitable donations that must be made available to stockholders annually, in a format to be prescribed by the SEC. Proxy disclosure is required only if the value of the charitable contribution exceeds an amount to be determined by the SEC, and then only if an insider serves as a director or trustee of the recipient charity. The bills proposed annual disclosure, however, would require an issuer to make available the aggregate amount of charitable donations made by it in any given year and, if any one particular charitable organization received donations in excess of an amount to be determined by the SEC, the name of such charitable organization and the value of the contribution made. As proposed, the annual disclosure is required even if no insider of the donor company serves as a director or trustee of the recipient charity.

We do not believe that, absent a significant direct relationship between the charity and an insider of the reporting company, disclosure regarding charitable donations is necessary for the protection of investors, or consistent with the Commission's charter and with the authority of the states to regulate corporate governance. No evidence has been presented by the proponents of the bill to indicate that such disclosure will cure a significant level of abuse or provide material disclosure necessary for the protection of investors. The additional regulatory burden imposed on the issuer should be balanced against the benefit to be gained. Unless the amount of contributions are material to the financial statements or business of the Company we see no reason why the disclosure of charitable contribution needs to be bifurcated. We would suggest that any required disclosure be restricted to the proxy statement and to instances when there is an insider involved with the charity in the manner we have proposed in 2. above. Many, if not most, charitable organizations are subject to state and federal regulatory review (IRS) and substantial financial information is open for public scrutiny as a matter of law. The bifurcated disclosure standard is unnecessarily complicated and poses an unnecessary regulatory burden on an issuer. Rather than imposing different requirements, one standard for proxy statement and annual report disclosure should be devised and an issuer should be allowed to incorporate by reference in its annual report the disclosure in its proxy statement, as is currently permitted with respect to Items 11 through 13 of Form 10-K.

4. *If disclosure is deemed necessary, stockholder proposals with respect to charitable donations should be precluded.*

If an issuer is required to make disclosure about charitable donations, such disclosure is likely to become the target of greater special interest group and political criticism regarding its choice of charities. Charities acceptable or even supported by one stockholder may be entirely unacceptable to another stockholder. The outcome of this could very well be a rash of stockholder proposals demanding that a particular charity be declared ineligible to receive future donations or that a different charity be the recipient of the company's gifts. The time and resources required to deal with such proposals alone would be a sufficient reason to limit the proposed disclosure. If, however, the proposed bill is enacted, it should at a minimum afford protection from stockholder proposals by declaring that charitable donations are "ordinary business" under the standard of Rule 14a-8(i)(7) and thus not a proper subject for action by an issuer's stockholders unless the proponent clearly demonstrates that the relationship to the charity is significant to the business of the company.

5. *The proposed disclosure could have a stifling effect on corporate charitable donations and is not necessary for the protection of investors.*

We believe that the bill's proposed disclosure requirement could have a stifling effect on corporate donations. To the extent that the gift programs of the companies become the target of stockholder complaints that either disagree with corporate giving generally or the specific recipients, it is likely that companies will restrict contributions to avoid the burden of disclosure. The negative impact on corporate philanthropy will almost certainly exceed any disclosure gain intended by the proposed statutory change. The central tenet of the securities laws is the protection of investors. What an investors needs to know to make an informed investment decision should not be equated with what a few investors, who may have a special interest or other non-corporate agenda, would *like* to know.

6. *The legislation is unnecessary.*

Finally, legislation on this subject is unnecessary. The Commission has ample authority under the Securities Act of 1933 and the Securities Exchange Act of 1934 to require any disclosure relating to charitable contributions that is actually material to investors.

We would welcome the opportunity for representatives of the BRT to meet with you on this matter.

Very truly yours,

WILLIAM C. STEERE, JR.

PREPARED STATEMENT OF DOROTHY S. RIDINGS, PRESIDENT AND CEO, COUNCIL ON FOUNDATIONS

The Council on Foundations and its more than 200 corporate grantmaking members continue to be concerned about the possible negative effects of H.R. 887 on charitable giving. The bill would amend the Securities and Exchange Act to require disclosures of contributions to nonprofit organizations. Although H.R. 887 is an improvement over similar bills introduced in the last Congress, and although the Council strongly encourages grantmakers to issue periodic reports informing the public about their gifts and grants, we question the need for federal legislation in this area. Particular problems with the bill include the prospect that it may deter volunteering and diminish giving. In addition, the measure delegates substantial authority to the Securities and Exchange Commission without affording necessary guidance on how the SEC is to exercise that authority. Finally, the bill fails to address serious issues with regard to the scope of required disclosure.

The Council on Foundations is a nonprofit association of more than 1800 grantmaking foundations and corporations. (A list of our corporate members is enclosed.) We estimate, based on market projections and other factors, that the 235 corporate grantmaker members of the Council will make more than $2.5 billion in charitable gifts in 1999. In addition to their financial resources, corporations also provide volunteer time, expertise, and visibility to the organizations they support. They are a vital and integral part of the charitable private sector. We hope that you will take our concerns into account as you consider H.R. 887.

Deterring volunteer activities. The first substantive provision of H.R. 887 would require publicly traded companies to disclose all contributions (above an amount to be set by the Securities and Exchange Commission) that the company makes to a nonprofit organization if a director, officer, or controlling person of the company is a director or trustee of the nonprofit. Disclosure also is required if a spouse of a covered individual serves on the nonprofit's board.

Many companies encourage their employees to become involved in community organizations, and many employees respond by generously donating their time to serve on community boards. Many companies also like to direct their giving to charities with which their employees are involved. We are deeply concerned that the disclosure requirement will place a strongly negative cast on this practice, leading key corporate employees and their spouses to resign their charity board positions lest they be perceived as having done something wrong. There is much reason to believe that volunteering by key corporate employees strengthens the social fabric of their communities, but correspondingly little evidence that this practice harms shareholders.

Discouraging Giving. The second provision of H.R. 887 requires publicly traded companies to disclose the names of nonprofits to which they made gifts and the amount they gave. Again, disclosure would be required only for gifts that exceeded a minimum amount to be established by the Securities and Exchange Commission. Currently corporations can decide whether and how they wish to publicize their gifts. H.R. 887 would remove this choice.

We are concerned that this Congressional action could have an adverse impact on charitable giving by publicly traded companies. While the Council encourages companies to report their philanthropic efforts to the community, it would be naıve not to acknowledge that charitable giving can be a sensitive issue for many corporations, especially those that deal directly with the public. We fear that some corporations may choose to eliminate giving programs rather than make disclosure. Others may decide to reduce the size of all contributions to a level below whatever minimum the SEC establishes. We urge you to keep in mind that corporate giving is an entirely voluntary expenditure. Nothing prevents a corporation from deciding that intrusive government regulation makes it undesirable to continue these gifts.

Promoting red tape. Many publicly traded corporations have numerous operating divisions and subsidiaries, each of which may have its own budget for charitable giving. If this legislation is enacted some of these companies likely will be required to invest in new software and tracking capability to collect and centralize information about the identity of all recipients and the amount of each gift. This task would be complicated by the need to accumulate gifts over the course of the year to determine whether the total exceeded the threshold established by the SEC. A further difficulty is that the answer to the threshold question may depend on how the recipient is organized. For example, because chapters of the American Red Cross are not separately incorporated, it would be necessary to accumulate all gifts to the various chapters. By contrast, local YMCAs and YWCAs are separate corporations (although often with multiple operating units), meaning that gifts to each corporate entity would be separately tracked.

Absence of necessary guidance to the SEC. H.R. 887 requires the Securities and Exchange Commission to establish a floor for both disclosure requirements. The only guidance to the SEC is that the amount it sets must be one that is "consistent with the public interest and the protection of investors." The bill leaves the SEC to guess what this level should be, since even total giving through corporate giving programs rarely, if ever, rises to the level of materiality—the standard the SEC normally applies in determining the need for disclosure. The height of the floor will have a significant impact on the record keeping burden that H.R. 877 will impose.

A related problem is that H.R. 887 does not include even the flawed provisions found in earlier versions of this legislation that attempted to reduce the size and scope of the burden the legislation would place on corporate givers. Thus earlier versions excluded from disclosure gifts of tangible property, gifts to public and private educational institutions, and gifts to local charities. The lack of similar provisions in this bill means that all gifts must be reported if they fall above the floor to be established by the SEC. Many corporate commenters on previous versions of this legislation also pointed out the burden involved if reportable gifts include all those made by a corporation pursuant to an employee gift matching program. H.R. 887 does not give the SEC the discretion to adopt a rule excluding matching gifts, except to the extent that matching gifts falling below the established floor will not be required to be disclosed.

The legislation also is vague on the gifts that must be disclosed. While the section heading is titled "Disclosure of Charitable Contributions," the text of the legislation mandates disclosure in connection with "contributions" to "any nonprofit organization." Charitable institutions—those organized and operated for a charitable purpose and exempt from tax under section 501(c)(3) of the Internal Revenue Code—are only one type of nonprofit organization. Examples of non-charitable nonprofits include trade and professional associations, civic leagues and social welfare organizations, social clubs, fraternal organizations, and a host of entities created for various pension and employee welfare purposes. H.R. 887 requires that contributions to these entities also would have to be tracked and disclosed.

Normal corporate checks and balances protect investors and the public. Corporate management generally makes charitable contribution decisions. Corporate management is directly accountable to the directors who represent the shareholders. Shareholders who are unhappy about how their corporation is run have the option of voting to replace the directors. This system is not perfect. But it is far preferable to micromanagement by the federal government, particularly in the absence of any concrete evidence that corporate giving is harming investors or the public.

In sum, the Council on Foundations is concerned that the risks of H.R. 887 substantially outweigh its benefits. We urge the subcommittee to consider carefully the need for injecting federal regulation into a system that currently works productively to provide substantial private voluntary support for a wide range of charitable organizations in all parts of the United States.

PREPARED STATEMENT OF THE U.S. SECURITIES AND EXCHANGE COMMISSION

Thank you for giving the Securities and Exchange Commission (SEC or Commission) the opportunity to present this statement concerning the disclosure of tax consequences of mutual fund investments and charitable contributions. The Commission fully supports the important goal of full disclosure, and welcomes this dialogue on these issues.

I. THE TAX CONSEQUENCES OF MUTUAL FUND INVESTMENTS

One of the Commission's primary goals with respect to mutual fund disclosure is ensuring that funds clearly present their performance and costs to investors. H.R. 1089, the Mutual Fund Tax Awareness Act of 1999, would address an important aspect of this issue, the effect of taxes on mutual fund performance. H.R. 1089 would require the Commission to revise its regulations to improve methods of disclosing to investors in mutual fund prospectuses and annual reports the after-tax effects of portfolio turnover on mutual fund returns. In fact, as more fully described below, the Commission staff is already working on improving disclosure in this area.

Current Disclosure Requirements

Mutual funds currently are required to disclose the following information about taxes in their prospectuses and annual reports:

- *Tax Consequences.* A fund must disclose in its prospectus the tax consequences to shareholders of buying, holding, exchanging, and selling the fund's shares, including the tax consequences of fund distributions.
- *Portfolio Turnover.* A fund must disclose in its prospectus whether the fund may engage in active and frequent portfolio trading to achieve its principal investment strategies and, if so, the tax consequences to investors of increased portfolio turnover and how this may affect fund performance. A fund also must disclose in its prospectus and annual reports the portfolio turnover rate for each of the last 5 fiscal years.
- *Distributions.* A fund must disclose dividends from net investment income and capital gains distributions per share for each of the last 5 fiscal years in its prospectus and annual reports.

Staff Consideration of Mutual Fund Tax Disclosure

The Commission staff has been considering whether mutual fund disclosure requirements could be revised to provide investors with a better understanding of the tax consequences of holding and disposing of a fund, the relative tax efficiencies of different funds, and how much of a fund's reported pre-tax return will be paid out by an investor in taxes. There is no direct correlation between the portfolio turnover rate, which currently is disclosed, and shareholder tax consequences. For example, a fund with high portfolio turnover may produce relatively low taxable gain to investors if it offsets realized gains with realized losses.

The Commission staff is considering whether there are other measures that could be used to convey mutual fund tax consequences that are understandable to investors and not unduly burdensome for funds to compute. Standardizing disclosure of the tax consequences of a mutual fund investment is complicated because different fund investors are in different tax situations and, therefore, may experience different tax consequences from the same fund investment.

The Commission staff's considerations have focused on after-tax return, a measure of a mutual fund's performance, adjusted to illustrate how taxes could affect an investor. (The calculation of after-tax return requires a number of assumptions about the investor's tax situation, such as his or her tax bracket.) The staff is considering two separate measures of after-tax return:

- *Pre-Liquidation After-Tax Return.* This measure assumes that an investor continues to hold the fund at the end of the period for which the return is computed. It measures only the taxes resulting to the investor from the portfolio manager's purchase and sale of portfolio securities.
- *Post-Liquidation After-Tax Return.* This measure assumes that an investor sells the fund at the end of the period for which the return is computed and pays taxes on any appreciation (or realizes losses). It measures both the taxes resulting from the portfolio manager's purchase and sale of portfolio securities and the taxes incurred by shareholders on a sale of fund shares.

These measures of after-tax return could help investors compare the after-tax returns of different funds and gain an understanding of the impact of taxes on a fund's reported pre-tax return.

Anticipated Commission Action

The Commission staff currently is preparing a recommendation to the Commission that it issue proposed rule amendments intended to improve the disclosure of the tax consequences of mutual fund investments. The proposed rule amendments, if issued, would be promulgated pursuant to the Commission's existing authority and would be the subject of public notice and comment.

II. DISCLOSURE OF CHARITABLE CONTRIBUTIONS BY PUBLIC COMPANIES AND MUTUAL FUNDS

H.R. 887 is a bill that would require public companies and mutual funds to disclose information about certain of their contributions to non-profit organizations where an insider of the company, or a spouse, is a director or trustee of the organization. In addition, public companies would be required to make available disclosure of the total value of contributions made and identify the donees and amounts contributed if they exceed a dollar threshold established by the Commission.

SEC Staff Study

At Representative Gillmor's request, the Commission staff has studied H.R. 887 and previous versions of the legislation. In fact, the staff requested comment from the public concerning the costs and benefits of the earlier legislation (H.R. 944 and 945). Nearly 200 persons commented. The vast majority of the commenters opposed the previous legislation. The commenters supporting disclosure argued that improved disclosure would reduce abuse, improve accountability, reduce shareholder distrust, provide another basis on which to assess the judgment of management, and build goodwill with the companies' customers and community. Opponents of disclosure argued that it would be costly to track small contributions, especially for large companies. They believed that companies would reduce the amount of gifts to avoid disclosure or avoid giving to controversial charities. There was concern this disclosure could be used for political or personal agendas.

After studying the issue, the Commission staff concluded that imposing the corporate charitable contributions disclosure requirements in H.R. 887 would be feasible in that public companies are capable of tracking and disclosing this information to investors. Many companies currently collect charitable contribution information for tax purposes, and a small number already voluntarily disclose this information to the public.

Current Disclosure Requirements

Currently, shareholders have a right to make proposals in the company's proxy statement to provide disclosure of charitable contributions. Those proposals have not attracted substantial support from shareholders. The Business Roundtable has commented that few shareholders request information regarding charitable contributions from companies that provide this information voluntarily. This leads us to believe that a significant majority of shareholders may not consider this information to be important.

In recent years, the Commission has been focusing much of its efforts on streamlining disclosure and mandating plain English. Charitable contributions account for a small portion of most companies' financial activities. We are cautious about adding disclosure that would add to the volume of detail given to investors without providing material information.

In the course of reviewing H.R. 887, the Commission staff identified additional practical issues that may affect the implementation of disclosure requirements for corporate charitable giving. Although companies already track the amount of their charitable contributions and to whom they are made for tax purposes, they may not have in place mechanisms to identify gifts to organizations affiliated with corporate insiders and their spouses, in part because they are not currently required to do so. Also, depending upon the dollar thresholds for disclosure, the amount of disclosure and the corresponding cost burden will vary significantly. Finally, there are other technical issues that the staff would be pleased to discuss.

III. CONCLUSION

The Commission supports the goals of H.R. 1089, the Mutual Fund Tax Awareness Act of 1999. Taxes have a significant effect on mutual fund performance, and the Commission and its staff are already working hard to improve the disclosure that funds make to investors in this area. The Commission remains concerned about H.R. 887. The Commission looks forward to working with the Subcommittee on these important issues.

OMB WATCH
November 2, 1999

Representative MICHAEL OXLEY
Chair, Finance and Hazardous Materials Subcommittee
House Commerce Committee
2125 Rayburn House Office Building
Washington, DC 20515

REPRESENTATIVE OXLEY: We are writing to ask that our statement be entered into the record of the recent hearing on H.R. 887.

We strongly support the ideal of disclosure, and feel it is vital to a democratic society. A large part of our mission involves working for greater openness in government. While we realize that there can be some downsides to full disclosure, we feel that the benefits far outweigh any of these. Therefore, we view H.R. 887 as a positive start for greater disclosure of corporate philanthropy, although clarification is needed on several points.

First, will the two disclosure requirements apply only to cash contributions made to nonprofits, or will they also include in-kind contributions? Many publicly held companies donate products that they manufacture, or services that they provide, to nonprofits. Also, many companies donate office equipment to nonprofits after making upgrades. It is important that these donations are also covered.

Second, clarification of the disclosure process in Section 2 is required. Currently there is no indication of what the process will involve, as the legislation simply states that the disclosure statement must be made "in a format designated by the [Securities and Exchange] Commission." We would strongly recommend that the data be widely available to the public using the internet. Also, allowing publicly held companies to submit the disclosure information electronically would ease any burden caused by the new requirements, as well as allow easy posting on the internet.

Even though clarifications are still needed, we feel that this is an important piece of legislation because it obliquely serves to codify the practice of corporate philanthropy. As Representative Cox pointed out at the hearing, by regulating disclosure of donations by publicly held companies, this law indirectly states that corporate philanthropy is allowed under SEC regulations.

Sincerely,

GARY D. BASS
Executive Director

Increasing Corporate Accountability?

OMB WATCH ANALYSIS OF H.R. 887

(7/06/99)

Summary

A bill introduced by Representative Paul Gillmor (R-OH) would require stock-issuing corporations that are registered with the Securities Exchange Commission (SEC) to disclose the amount of money they have given to charities each year, as well as the names of recipients of large grants, through two processes. The first would require the disclosure of any contribution over a limit to be set by the SEC to any nonprofit of which "a director, officer, or controlling person" of the corporation "or a spouse thereof was a director or trustee" to be included in the annual proxy statement. This would include the name on the nonprofit, and the amount of the contribution.

The second process requires all corporations to annually "make available" the "total value of contributions made by the issuer to nonprofit organizations during its previous fiscal year." This process would also require the name of the nonprofit organization receiving the donation to be included in the report, as well as the amount contributed, if the contribution is over an amount set by the SEC.

Background

Gillmor proposed a similar piece of legislation in the 105th Congress (H.R. 944). That bill simply called for "disclosure of the issuer's charitable contributions during the preceding fiscal year, including the identity of and the amount provided to each recipient." The legislation was not as comprehensive as this year's bill, H.R. 887, as it allowed the SEC to grant several types of exemptions. It was also partnered with another bill (H.R. 945) that would have required the approval of shareholders for any charitable contributions. Taken together, these bills would have created substantial barriers to corporate giving, and would have made contributions far less attractive to companies.

Gillmor asked the SEC to evaluate the feasibility of requiring disclosure to shareholders in the spring of 1997, and the SEC finally released a report early this June. While the report covers general principles of disclosure, it focuses on H.R. 887. The report finds that the "corporate charitable disclosure requirements in H.R. 887 would be feasible in that companies are capable of tracking and disclosing this information to investors." The report notes that many companies already track charitable contributions for tax purposes, and some already voluntarily disclose their contributions to the public. Gillmor also asked that the SEC perform a cost and benefit analysis, but this was not included in the report.

Analysis

OMB Watch supports the ideals of accountability and disclosure in the nonprofit sector. This bill is a good beginning for greater disclosure. Unlike foundations, public corporations are not now required to disclose information about their contributions or grants. Principles have been in place for some time regarding disclosure of philanthropic endeavors. The Council on Foundations, for example encourages its members to disclose information about contributions in annual reports. It should not be difficult for a corporation to print a listing of contributions in its annual proxy statement. Further, the SEC should allow for electronic submission of the disclosure information for ease of submission, and post it on the internet for simple public access.

Disclosure of charitable contributions by corporations should not be a controversial issue, nor is it costly to implement. If the intent of the bill is to increase corporate accountability, it is interesting that it only applies to corporate contributions. Why not include information disclosing lobbying expenditures, campaign contributions (both "hard" and "soft" money), expenditures for legislative, ballot and regulatory issue campaigns, as well as other information in annual reports? Disclosure of contributions to charities is a good start, but is only a small part of corporate accountability.

Another important piece of the legislation is a provision that requires the disclosure of any contributions over a limit to be determined by the SEC made by a company to any nonprofit organization "of which a director, officer, or controlling person" of the company, or the person's spouse is a "director or trustee." This provision would allow the public to see contributions that may be made simply because of an executive's involvement with an organization. For example, under this bill a corporation which makes a contribution simply as a "fee" for an executive's seat on a nonprofit board may be required to disclose this contribution if it is above the SEC designated amount.

Potential Problems:

As drafted, this legislation does not apply to corporate foundations. This could impede full disclosure, because a company seeking to avoid disclosure could simply make a large payment to its foundation, and then have the foundation make contributions. The company would only be obligated to disclose its contributions to its foundation (assuming that the contribution exceeds the threshold that is to be determined by the SEC). There will be some level of disclosure, however, because private foundations are required to disclose contributions in their IRS form 990-PF. While these documents are available for public inspection, they are most likely not delivered to shareholders on a yearly basis, as an annual report is.

Another problem with this legislation is that contributions to charities where an executive is a director or trustee are only disclosed to shareholders, and not necessarily the general public. This disclosure is to be included with the written information distributed to shareholders before the corporation's annual meeting, which usually is an annual report. While most corporations will give a copy of their annual report to non-shareholders, they are under no obligation to do so. The general public should have access to a corporation's total charitable contributions as well as the names of charities receiving contributions over the threshold that is to be set by the SEC, preferably in an easily accessed electronic format. The legislation does state that this information must be made available "in a format designated by the Commission," but does not state who this information is to be made available to, nor does it give any hint as to the format.

It is unclear if this legislation applies to contributions made by U.S. companies to foreign nonprofit organizations. Donations made by U.S. corporations to foreign nonprofits may not be disclosed, as they are not tax-deductible, and may not fall under a final definition of "contribution." The legislation also appears to apply to contributions to U.S. charities made by foreign companies that are "registered" with the SEC. These foreign companies may be subject to domestic laws that may conflict with the purposes of this bill, and there may be difficulty enforcing this legislation in foreign companies.

Conclusion

While disclosure of corporate charitable contributions is the right thing to do, is unlikely to have a major impact on corporate accountability. Legislation is still needed requiring corporations to disclose other types of contributions, such as "soft money" campaign contributions. Further, because the reporting threshold has not yet been set by the SEC, the impact of H.R. 887 cannot be fully measured.

PREPARED STATEMENT OF HON. JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

The Subcommittee on Finance and Hazardous Materials held a hearing on H.R. 887, legislation to mandate the disclosure of certain corporate charitable contributions, and H.R. 1089, the Mutual Fund Tax Awareness Act of 1999, on Friday, October 29, 1999, when the House was not in session and only three Subcommittee Members (Reps. Gillmor, Markey, and Cox) were able to attend.

The hearing was chaired by Rep. Gillmor, the lead sponsor of both bills. Rep. Gillmor announced that the hearing record would be held open to allow other Members to insert their statements. I appreciate that courtesy and will avail myself of the opportunity to clarify the record.

First, I note that both bills amend the federal securities laws to mandate that the Securities and Exchange Commission (SEC) require certain disclosures. Yet, in a departure from usual subcommittee practice, the SEC was not invited to testify on the legislation. I have subsequently learned that the Majority did ask the SEC to submit a written statement but that statement was not made available to Members either before or during the hearing. It appears that the SEC statement raises concerns with at least one of the bills. I am submitting the SEC statement for inclusion in the record and circulating it to Democratic Members.

Similarly, in May 1997, six Members of the Subcommittee wrote to the SEC asking for a report on predecessor legislation to H.R. 887. The SEC staff report was not distributed to Members with the briefing materials for this hearing or included in the hearing record. The briefing memorandum mentions the SEC staff report's finding that "imposing the corporate charitable contributions disclosure requirements in H.R. 887 would be feasible in that public companies are capable of tracking and disclosing this information to investors." However, it does not mention any of the concerns and problems that also were discussed. Therefore, I am submitting copies of the May 1997 letter and the May 1999 SEC staff report for inclusion in the hearing record as well.

No mention of a markup date was made at Friday's hearing. At 5:30 p.m., after most offices were closed for the weekend, the Majority sent out a notice that both bills would be scheduled for Subcommittee markup on Tuesday, November 2, 1999. The SEC was not notified of the markup. No meeting has been scheduled in advance of the markup with the SEC to discuss and address their concerns.

With respect to the substance, H.R. 1089 would require the SEC to revise its regulations to improve the methods of disclosing to investors in mutual fund prospectuses and annual reports the after-tax effects of portfolio turnover on mutual fund returns. SEC staff currently is preparing a recommendation to the Commission that the agency issue proposed rule amendments, under its existing statutory authority, with the intention of improving the disclosure of the tax consequences of mutual fund investments. This issue is complex, as was noted by the witnesses. Every investor's tax situation differs and, short of person-by-person disclosure, it will be difficult to craft meaningful disclosures. Any disclosure in this area will have to be accompanied by clear cautionary narrative informing investors of the appropriate use and inherent limitations of any new tax information. This legislation is not necessary, but may provide a beneficial prod, as long as the SEC is given sufficient flexibility in implementing the legislation's goals. The SEC has submitted a package of technical changes to H.R. 1089. These should be taken care of.

H.R. 887 requires all SEC-registered companies to annually make available, in a format to be designated by the SEC, the total value of contributions made by the issuer to nonprofit organizations during the previous fiscal year. The name of the organization receiving the donation and the amount contributed also must be included in the report for any contributions over a threshold amount to be set by the SEC. H.R. 887 also requires SEC-registered companies to disclose in their proxy statements any contributions, over threshold to be set by the SEC, made by the issuer during the previous year to any nonprofit organization of which a director, officer, or controlling person of the issuer, or spouse thereof, was a director or trustee, including the name of the organization and the value of the contribution.

Concern has been raised that this disclosure could be used in furtherance of improper political or personal agendas. Moreover, if the intent of the bill is to increase corporate accountability, it is curious that it only applies to corporate charitable contributions. Disclosure of contributions to charities is only a small part of corporate accountability. Why not include information disclosing lobbying expenditures, campaign contributions (both "hard" and "soft" money), expenditures for legislative, ballot, and regulatory issue campaigns, as well as other significant information?

In addition, the SEC staff report on H.R. 887 raises the following specific concerns:

(1) There does not appear to be evidence of widespread (or even significant) abuse—only a handful of examples or allegations have been provided.

(2) Information regarding charitable giving by corporations is currently available:
- Some companies voluntarily make available information regarding their charitable contributions to shareholders.
- Corporate private foundations are required, under IRS regulations, to make a list of contributions available to the public, and apparently the IRS is amending its regulations to improve public access.

(3) There does not appear to be evidence of widespread shareholder interest in obtaining this information:
- Companies that make such information available to shareholders have found relatively low shareholder interest.
- Only a small number of shareholder proposals for disclosure of charitable contributions have been offered and voted upon, and none have been approved by shareholders.

(4) The information may not be material to investors since it may not be considered relevant to a reasonable person's investment decision, particularly if the donations are not improper:
- Corporations donate an average of a mere one percent of their pretax income to charity.
- The SEC generally requires disclosure of information that is is "material" so that disclosure is meaningful and does not overwhelmshareholders. Only in very rare instances, if at all, would corporate charitable contributions meet any reasonable "materiality" standard.

(5) Companies may evade the disclosure required by the bill:
- By making contributions through their foundations;
- By making contributions below any threshold; and

- By characterizing payments as business expenses instead of charitable contributions.

(6) The costs of compiling the information may not be as low as proponents anticipate because companies may not have centralized records of all types of contributions including cash, products, services, use of facilities and time of employees.

I intend to vote against H.R. 887 in its current form.

U.S. House of Representatives
Committee on Commerce
Room 2125, Rayburn House Office Building
Washington, DC 20515–6115

May 23, 1997

The Honorable Arthur Levitt
Chairman
Securities & Exchange Commission
450 5th Street, N.W.
Washington, D.C. 29549

Dear Chairman Levitt:

Pursuant to Rules X and XI of the House of Representatives, and our continuing oversight of securities and exchanges, we are writing to request that the Securities and Exchange Commission conduct a study of the feasibility of promoting additional shareholder participation in corporate charitable giving.

We understand that Warren Buffet has initiated a program to increase shareholder involvement in the corporate giving of Berkshire Hathaway. In that program, shareholders of Berkshire Hathaway are afforded the opportunity at the annual shareholders meeting to designate charities that will benefit from the charitable giving of the corporation. We are intrigued whether this innovative approach to involving shareholders in corporate decision making on charitable gifts could be replicated in other contexts.

Representative Paul Gillmor has introduced two bills in the 105th Congress, H.R. 944 and H.R. 955, that address this question. In the reauthorization hearing of March 6th before the Subcommittee on Finance and Hazardous Materials, you indicated to Representative Gillmor that the SEC would be willing to conduct a study of the issues contained in this legislation. We request that the SEC conduct such a study and submit a report to us of the results of that study.

Specifically, we request that the SEC study the feasibility of: (a) requiring disclosure documents accompanying any annual report of a registered security to include disclosure of the issuer's charitable contributions during the proceeding fiscal year, including the identity and amount contributed to each recipient (excluding diminimis amounts); and (b) requiring that issuers of public securities afford their shareholders the opportunity, on a basis proportional to the number of shares owned by such shareholders, to designate recipients of charitable contributions from the issuer. The study should include an analysis of the costs and benefits of imposing such requirements.

The Honorable Arthur Levitt
May 22, 1997
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Please submit your report within six months of the receipt of this letter. Thank you for your cooperation and attention to this request.

Sincerely,

Paul E. Gillmor
Vice Chairman

Tom Bliley
Chairman

Michael G. Oxley
Chairman
Subcommittee on Finance
and Hazardous Materials

John D. Dingell
Ranking Minority Member

Thomas J. Manton
Ranking Minority Member
Subcommittee on Finance
and Hazardous Materials

Edward J. Markey
Ranking Minority Member
Subcommittee on Telecommunications,
Trade, and Consumer Protection

PEG:dlc

REPORT OF THE STAFF OF

THE DIVISION OF CORPORATION FINANCE OF

THE U. S. SECURITIES AND EXCHANGE COMMISSION

ON H. R. 887

REGARDING DISCLOSURE OF CHARITABLE CONTRIBUTIONS

MAY 1999

Executive Summary

While it is now common for American corporations to contribute to charitable organizations, it is a relatively recent practice. In 1998, American corporations donated an average of nearly one percent of their pre-tax income to charitable organizations. In 1998, an estimated 26.4 percent of corporate contributions were made through private foundations.

At the request of Rep. Paul Gillmor, the Commission staff examined the feasibility of implementing provisions in H.R. 887 that require public companies and mutual funds to disclose, in their SEC filings, information about their contributions to non-profit organizations. In response, this report, prepared by the Commission's staff, examines (1) the history of corporate charitable giving and disclosures, including current corporate practice and shareholder proposals; (2) pending and previous legislative proposals in this area; and (3) applicable securities and tax law issues.

The Commission staff believes that imposing the corporate charitable contributions disclosure requirements in H.R. 887 would be feasible in that public companies are capable of tracking and disclosing this information to investors. Many companies currently collect charitable contribution information for tax purposes, and a small number already voluntarily disclose this information to the public. However, charitable contributions account for a small portion of a company's financial activities. And, for the most part, the total amount of corporate charitable contributions is small in relation to the total amount of all charitable contributions made in this country each year. It is also unclear whether disclosure of such contributions would be material to investors. In addition, the Commission staff did not estimate the costs to public companies of disclosing their charitable contributions.

Currently, neither federal nor state laws provide a uniform framework for the disclosure of corporate charitable giving. For purposes of such disclosure, federal and state *tax* laws distinguish between direct corporate contributions and those made by a private foundation established by the corporation for this purpose. However, federal *securities* laws do not require public companies to disclose this information, and the Commission does not monitor companies' activity in this area. Federal tax laws require corporations to report the total amount of contributions for which they choose to claim a tax deduction. While the tax code requires proof of these contributions, shareholders and the public generally do not have access to the corporation's tax return. The federal tax code does require private foundations and public charities, however, to file annual informational returns, which are required to be made available for public inspection. Similarly, many states require private foundations, but not corporations, to disclose their charitable contributions.

In addition to reviewing nearly 200 comment letters on previous legislative proposals, the Commission staff examined the charitable giving disclosure practices of the public Fortune 100 companies. The evidence gathered by the SEC staff points to significant variation in the current practice of disclosing charitable giving by these corporations, both in degree and in scope. For instance, some companies disclose the total amount contributed by the corporation, others the amount contributed by the foundation, and others a combination of both. None of the Fortune 100 companies reviewed by the staff disclose all of their contributions in their annual glossy report. Thirteen of the Fortune 100 disclose the total dollar amount that they contributed to charity in the previous year. Few companies disclose the names of recipients. Companies also sometimes publish reports, of varying detail and separate from their glossy annual reports, on the charitable contributions of the company and/or the corporate foundation. The ease of obtaining these reports varied among companies. It is also unclear whether the information disclosed by companies represents the full extent of their charitable contributions. Because no standardized reporting mechanism exists for reporting charitable contribution information, it is difficult to establish, based on the Commission staff's analysis, consistent patterns of corporate disclosure. However, the report outlines in further detail the varying types of disclosures done by these companies.

The Commission staff has examined shareholder proposals that would have required increased disclosure of corporate charitable contributions -- the report includes several examples. However, these proposals have represented a small percentage of all shareholder proposals. To the extent these proposals have been submitted to a vote, they have received only limited shareholder support.

In the course of conducting this study, the Commission staff identified additional practical issues possibly affecting the implementation of increased disclosures of corporate charitable giving. Although companies already track the amount of charitable contributions and to whom they are made for tax purposes, they may not have in place mechanisms to identify potential conflicts of interest in the giving process, in part because they are not currently required to do so. Also, depending upon the dollar thresholds for disclosure, the amount of disclosure and the corresponding cost burden will vary significantly. In the case of mutual funds, the staff found that the vast majority do not contribute to charitable causes. Consequently, it may be unnecessary to subject mutual funds to the disclosure requirements. As Congress assesses the need for additional disclosure requirements, we are confident the attendant cost on all public companies will be carefully weighed.

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I. INTRODUCTION

In 1998, Americans gave an estimated $174 billion to charitable organizations. 1/. The vast majority of the contributions, 77.3 percent, were made by individuals. 2/ Corporations, both public and private, and their corporate foundations made over five percent of the contributions, or almost $9 billion of the $174 billion. 3/ In 1998, corporations donated an average of approximately one percent of their pre-tax income to charitable organizations. 4/

In March 1999, Representative Paul Gillmor introduced a bill that would require public companies and mutual funds to disclose, or otherwise make available, information regarding their contributions to nonprofit organizations. A copy of the bill, H.R. 887, is attached as Exhibit A. Congressman Gillmor asked the Commission to examine the feasibility of the bill. This report discusses the results of the examination undertaken by the Commission staff. While the Commission staff has expertise in corporate disclosure generally, its expertise does not extend to cover the merits of charitable giving or the substance of various laws affecting charitable giving, including state fiduciary law and federal tax law. Nonetheless, in examining H.R. 887, and prior legislation, the Commission staff did consider disclosure requirements for corporate charitable giving under state fiduciary law and federal tax law.

II. HISTORICAL BACKGROUND

While it is now common for American corporations to make contributions to charitable organizations, it is a relatively recent practice. Traditionally, corporations were not expected to serve society; they were expected to serve only their shareholders. The law reflected this lack of expectations. Under common law, corporations were not permitted to make donations. Any such donations were considered "ultra vires," beyond the powers of the corporation.

In the late nineteenth century, however, the law began to change. American courts began to recognize an incidental power of the corporation to make charitable contributions,

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1/ See SEC AAFRC Trust for Philanthropy, Giving USA 1999: Executive Summary of the Annual Report on Philanthropy for the Year 1998 10 (1999).

2/ See id. The remainder was given by foundations (not including corporate foundations), bequests, and corporations.

3/ See id. The actual numbers are $174.52 billion and $8.97 billion.

4/ See id. This amount does not include funds transferred by corporations to their foundations. Many corporations establish private foundations through which charitable contributions are made. See Section IV of this report for a discussion of this practice.

but only if the contribution "served corporate ends...in a substantial, and not in a remote or fanciful sense. . . ." 5/ By the 1950's, the courts were recognizing broader responsibilities of corporations. In the landmark case of A.P. Smith Mfg. Co. v. Barlow, the New Jersey Supreme Court stated that "modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate." 6/

In the early part of this century, federal tax laws relating to charitable giving by corporations also changed. Until 1936, the tax laws did not provide a tax deduction for charitable contributions made by corporations. The only way for a corporation to get a deduction was for the corporation to claim that the charitable contribution was a business expense that would directly benefit the corporation. In 1936, Congress enacted the Revenue Act of 1936 which permitted corporations to deduct the value of charitable contributions without having to demonstrate that the contribution directly benefited the corporation. Under the Act, corporations could not deduct more than five percent of their income. In 1981, however, Congress raised the limit to ten percent.

Beginning in 1917, states also began enacting statutes authorizing corporations to make philanthropic contributions. These early statutes, however, contained numerous restrictions on corporate giving practices. Several states required that the board of directors approve all contributions. Hawaii required shareholder approval. Other states limited the amount of individual contributions or limited the geographic location of recipients.

Some states even briefly required corporations to disclose their contributions. In 1920, Ohio enacted a statute requiring corporations incorporated in that state to report annually their charitable contributions to the secretary of state. 7/ Ohio eliminated this provision in 1927 when it revised its corporate laws. New York's disclosure requirement had an even shorter life. In 1950, New York State required corporations incorporated in New York to disclose, in their annual reports, the names of recipients of charitable contributions of more than $500 and the amount of each contribution. 8/ The law was controversial when it was enacted. It was repealed the following year.

5/ Steinway v. Steinway & Sons, 40 N.Y.S. 718 (1896).

6/ A.P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 98 A.2d 581 (1953); compare Dodge v. Ford, 204 Mich 459, 507 (1919) ("A business corporation is organized and carried on primarily for the profit of stockholders. . . . The discretion of directors . . . does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.").

7/ See Act of February 4, 1920, 108 Ohio Laws 1245 (repealed 1927).

8/ See Act of March 30, 1950, ch.297, § 1, 1950 N.Y. Laws 974, 975 (repealed 1951).

Beginning in the 1950's, states began enacting statutes, inspired by the American Bar Association Model Corporation Act, that gave corporations authority to make "donations for the public welfare or for charitable, scientific, or educational purposes." 9/ Today, all 50 states and the District of Columbia have similar provisions in their corporate laws. At least three states (Arkansas, New Jersey, and Maryland) require that the board of directors approve all charitable contributions. The state provisions based on the Model Business Corporation Act have been interpreted broadly. For instance, in Delaware, charitable contributions are valid if they are reasonable in amount and purpose. 10/ The debate, however, over the extent to which corporations should make charitable contributions continues. 11/

III. DESCRIPTION OF PENDING AND PREVIOUS LEGISLATION

A. DESCRIPTION OF H.R. 887

H.R. 887 would apply to reporting companies that have securities registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") and to investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act").

1. AGGREGATE AMOUNT OF CONTRIBUTIONS

Section 2 of H.R. 887 would require reporting companies and mutual funds to make available, each year, the total value of contributions that they made to nonprofit organizations during the previous fiscal year. The bill grants the Commission the authority to "designate" the "format" in which such information would be made available.

2. SPECIFIC CONTRIBUTIONS ABOVE A THRESHOLD

Section 2 of H.R. 887 would also require reporting companies and mutual funds to make available the names of the nonprofit organizations to which they made a contribution during the previous fiscal year and the amount of the contribution where the value of the contribution exceeds a threshold amount. The bill grants the Commission the authority to "designate" the threshold amount "consistent with the public interest and the protection of investors."

9/ Model Business Corporate Act § 3.02(13) (1946).

10/ See Theodora Holding Corp. v. Henderson, 257 A.2d 398 (Del. Ch. 1969).

11/ Some scholars have argued that social activism is inconsistent with the main responsibility of corporations. See Milton Friedman, The Social Responsibility of Business is to Increase its Profits, N.Y. Times Magazine, September 13, 1970, at 33.

3. DISCLOSURE OF CONTRIBUTIONS WHERE THERE WAS A CONFLICT OF INTEREST

Section 1 of H.R. 887 would require reporting companies and mutual funds to disclose in their proxy statements contributions that the company made to nonprofit organizations during the company's previous year 12/ where:

(1) the value of the contribution exceeds a threshold amount; and
(2) a director, officer or controlling person of the issuer or a spouse of such a person, was also a director or trustee of the nonprofit organization.

The bill grants the Commission the authority both to "designate" the threshold amount and to define the terms "executive officer" and "controlling person" consistent with the public interest and the protection of investors. 13/ If a conflict of interest exists and if the value of the contribution is above the threshold, then the company would be required to disclose the name of the nonprofit organization and the value of the contribution.

B. DESCRIPTION OF H.R. 944 AND H.R. 945

In the last Congress, Congressman Gillmor introduced two bills, H.R. 944 and H.R. 945, relating to corporate charitable contributions. The bills are attached as Exhibit B.

H.R. 945 would have required public companies and investment companies to let their shareholders participate in the designation of recipients of the company's charitable contributions.

H.R. 944 would have required disclosure of all contributions, whether directed by management or by shareholders. The bill would have required public companies each year to disclose to their shareholders the charities to which they made contributions and the amount of each contribution. Under H.R. 944, the disclosure would have been made in a proxy statement or in other disclosure statements accompanying any proxy, consent or authorization solicited by or on behalf of the management of a company.

Both H.R. 944 and 945 would have granted the Commission authority to adopt exemptions from the disclosure requirements for the following:

(1) gifts of tangible personal property (such as products produced by the company);

12/ Section 1 does not use the term "fiscal year" but only uses the term "issuer's previous year." Section 2 uses the term "its previous fiscal year."

13/ The bill does not use the term "executive officer" but uses the term "officer" in the text.

(2) gifts to public or private nonprofit educational institutions; and
(3) gifts to local charities.

The Commission solicited public comment on these two bills. In response to these comments, Congressman Gillmor introduced H.R. 887 in the 106th Congress.

IV. CORPORATE PRACTICES REGARDING CHARITABLE CONTRIBUTIONS

Companies appear to have no uniform procedure for selecting recipients and determining the amounts of charitable contributions. Usually these determinations are left to management and do not involve directors. In some cases, however, state law or corporate practice may require that the board of directors approves the donations. 14/

Companies make charitable contributions in a variety of ways including making non-cash contributions, matching the charitable contributions of their employees and making charitable contributions to organizations outside the United States. A company may make contributions to charitable organizations directly through the company and indirectly through a corporate foundation established for that purpose. If a company has a foundation, the company makes donations to the foundation, and the foundation, in turn, makes contributions to charitable organizations. Companies that establish foundations are not obligated to make all of their contributions through the foundation. In 1998, an estimated 26.4 percent of corporate contributions were made through foundations. 15/ Giving by corporate foundations grew by 14.8 percent from 1997 to 1998, while direct corporate giving grew by only 9.3 percent. 16/ Generally, the foundation is managed by the company. Foundations sometimes make matching contributions on behalf of corporate employees.

There are several benefits to a company making at least some of its contributions through a foundation. A major benefit is that a company can donate cash or property to the foundation in years when it wants a tax deduction and have the foundation make contributions in subsequent years, when the company may not have the profits to support donations to charitable causes. In addition, foundations can make contributions to foreign charities and receive a tax deduction whereas companies cannot do so directly.

14/ For example, Arkansas, New Jersey and Maryland require that the board of directors of companies incorporated in those respective states approves all charitable contributions.

15/ See AAFRC Trust for Philanthropy, Giving USA 1999: Executive Summary of the Annual Report on Philanthropy for the Year 1998 10 (1999), based on statistics from The Foundation Center. Specifically, it is estimated that in 1998 corporations contributed $6.6 billion to charity while corporate foundations contributed $2.37 billion. Id. at 2.

16/ See id. at 2.

While there are these benefits, foundations are subject to reporting and disclosure requirements under the Internal Revenue Code (the "Code"), as discussed below, that do not apply to companies.

V. REASON FOR SHAREHOLDER CONCERN

As discussed above, there are few legal limits on charitable giving by companies. Some fear that the lack of limits leaves the potential for abuse. 17/

The federal securities laws generally do not require disclosure of charitable contributions unless: (1) the contributions are material to an investor's understanding of the company's business or financial statements, or its compensation policies; or (2) the contribution is made by the company to another entity where a conflict of interest exists and the amount is significant. 18/ Since the Commission staff does not monitor corporate charitable contributions, it is not in a position to be aware of any particular abuse by public companies or their directors or officers regarding corporate contributions to nonprofit organizations.

Even those monitoring contributions may have difficulty detecting if there has been abuse, because information on specific contributions may not be available to shareholders, the public generally, or the Commission. 19/ Even if a company discloses its charitable contributions, it would be difficult to determine if a contribution was inappropriate without knowing who directed the company to make the contribution and whether that person, or others, had a relationship with the recipient.

17/ One professor who has studied this matter wrote that the lack of federal or state standards for corporate donations leaves "the potential for gross management abuse of shareholders' property and speech interests." Faith Stevelman Kahn, Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy, 44 UCLA L. Rev. 579, 585 n.17 (1997).

18/ See Sections VI.B.1. and VI.B.3. of this report for a discussion of Commission rules requiring disclosure of corporate charitable giving practices where it involves compensation policy and conflict of interest transactions, respectively.

19/ In some cases, shareholders interested in a company's giving practices are unable to get satisfactory answers. For example, one shareholder contacted the Commission after the company in which she owned shares refused to provide her with a list of its contributions. See Comment Letter from Fredericka Danielus, January 30, 1998.

Critics of corporate charitable contributions have alleged that some corporate officials use contributions for personal reasons. 20/ A recent newspaper article noted that members of boards of prestigious art museums and performing arts centers are expected each year to make substantial contributions themselves or are expected to have their companies and or friends do so. 21/ Other critics have alleged that corporate executives favor charities in which they serve as officers or directors. 22/

A few charitable contributions made by companies have been publicly questioned. For instance, shareholders challenged the multimillion dollar contribution that Occidental Petroleum, Inc., made to fund the Armand Hammer Museum of Art and Cultural Center, named after Armand Hammer, Occidental's Founder and Chairman. 23/ One book, Barbarians at the Gate, contains accounts of several contributions that were made at the direction of the CEO of RJR Nabisco to gain favor with his superior (before he became

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20/ One former CEO of a Fortune 500 company, Alfred Dunlap, has written that:

> [c]orporate charity exists so that CEOs can collect awards, plaques and honors, so they can sit on a dais and be adored. That is not what the shareholder is paying them a million bucks a year--plus stock options and bonuses--to do!

Albert J. Dunlap, Mean Business, 200 (1996).

21/ See Buying Your Way On to a Board, The Wall Street Journal, May 7, 1999, pp.W1, W4.

> "[M]ost institutions have a "give or get" policy: If you can talk a rich friend or corporation into donating some money, that's considered part of your total pledge. Some organizations also count those pricey tables at benefits, as well as the value of donated services, toward your tithe."

The amounts range as high as $100,000 per year.

22/ In his Comment Letter, April 13, 1998, Professor Melvin A. Eisenberg, Koret Professor of Law, University of California at Berkeley, asserted:

> In some cases. . . there is reason to believe that charitable contributions are made to further the interests of officers, directors, or controlling shareholders. The most obvious case is that in which Business Corporation P makes a contribution to Nonprofit Entity N and an officer, director, or controlling person of P is also an officer, director, or controlling person of N.

23/ See Kahn v. Sullivan, 594 A.2d 48 (Del. 1991).

CEO) and board members. 24/ These donations were made to schools that the superiors and board members had attended or were otherwise affiliated with. In addition, according to the authors, the Chairman of R.J. Reynolds directed the company to make contributions to a school to influence a board member. 25/ While some argue that these are isolated examples, others claim that these are "not exceptional." 26/ One law school professor states that:

> contributions to pet projects of powerful team members probably happen on a small scale very frequently. But, it is rare that they are this large [referring to Occidental Petroleum's $85 million grant to the Armand Hammer Museum], relative to the size of the companies involved. 27/

VI. CURRENT REPORTING AND DISCLOSURE REQUIREMENTS

A. FEDERAL TAX REQUIREMENTS FOR REPORTING AND DISCLOSURE OF CHARITABLE CONTRIBUTIONS

1. CORPORATIONS

Under the Code, a corporation is required to report the total amount of contributions for which it is claiming a tax deduction. The deduction is a separate line item on the corporate tax return. The corporation must maintain evidence for each and every contribution in the form of a receipt from the charitable organization. Under the Code, however, shareholders and other persons do not have access to the corporation's tax return unless the shareholder owns at least one percent of the corporation's stock. 28/

2. CORPORATE FOUNDATIONS

All private foundations, including corporate foundations, are required to file an informational return on Form 990-PF with the Internal Revenue Service ("IRS") each year. Congress has subjected private foundations to more stringent disclosure and public inspection

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24/ See Bryan Burrough and John Helyar, Barbarians at the Gate: The Fall of RJR Nabisco, 29, 33-34, 82, 97 (1990).

25/ See id. at 59-61.

26/ Jayne W. Barnard, Corporate Philanthropy, Executives' Pet Charities and the Agency Problem, 41 N.Y. Law School L. Rev. 1147, 1163 (1997).

27/ Margaret M. Blair, A Contractarian Defense of Corporate Philanthropy, 28 Stetson L. Rev. 27, 46 (1998).

28/ See I.R.C. § 6103(e)(1)(D)(iii) (1998).

requirements than public charities for two reasons. First, there is a perception that private foundations have engaged in more abusive practices than public charities. 29/ Second, there is fear that subjecting public charities to extensive regulation would hinder these organizations, which rely heavily on the support of the general public.

a. Reporting Obligations

A private foundation must report, in Form 990-PF, contributions that it received from any single source that total $5,000 or more during the year. Specifically, the foundation must report the name and address of each such donor and the total amount of the contributions received from each donor. 30/ In addition, a private foundation must report all grants and contributions made during the previous year (including those grants and contributions made to other tax-exempt organizations), regardless of the amount of any single distribution. Specifically, it must report the name and address of each recipient and the amount of each donation that the private foundation made to that recipient. 31/ Form 990-PF requires that private foundations report additional information including whether an individual recipient of a donation is related to the officers or directors of the private foundation by blood, marriage, adoption, or employment. 32/

b. Public Access to Returns Filed By Private Foundations

Any person, including a shareholder, can obtain a list of all contributions made by a corporate foundation from either the foundation itself, under limited circumstances, or the IRS.

29/ See Robert C. Degaudenzi, Tax-Exempt Public Charities: Increasing Accountability and Compliance, 36 Cath. Law. 203, 217 (1995); Staff of Joint Comm. on Internal Revenue Taxation and Comm. on Finance, 91st Cong., 1st Sess., Summary of H.R. 13270, The Tax Reform Act of 1969 21 (Comm. Print 1969); and Staff of the House Comm. on Ways and Means, 98th Cong., 1st Sess., Development of the Law and Continuing Legal Issues in the Tax Treatment of Private Foundations 11 (Comm. Print 1983).

30/ See Instructions for Form 990-PF, Line 1. In calculating whether a series of contributions from a person or entity meet or exceed the $5,000 contribution threshold, a tax-exempt organization need only include those contributions from the respective donor that are at least $1,000 or more.

31/ See Instructions for Form 990-PF, Line 25. See also I.R.C. § 6033(c); Form 990-PF Pt. XV, Line 3.

32/ See Form 990-PF Pt XV line 3; Instructions for Form 990-PF at 13 (1998).

i. Access to Returns Through The Private Foundation

In 1996, Congress enacted the Taxpayer Bill of Rights which requires private foundations and public charities to provide copies of their informational returns to persons who request them in writing or in person. 33/ However, the Act does not apply to private foundations until 60 days after the IRS issues final rules. The IRS has not yet proposed rules applicable to private foundations. On April 9, 1999, the IRS issued final rules applicable to public charities and announced that it intends to issue "shortly" a notice of proposed rulemaking that would revise the disclosure requirements for private foundations so that they mirror the revised rules that apply to public charities. 34/

Under the current rules, however, private foundations are required to provide only limited public access to their informational returns. Private foundations are required to make their annual informational returns available for public inspection at the foundations' offices. 35/ Private foundations are required to publish a notice as to the availability of this information in a newspaper having general circulation in the county in which the principal office of the private foundation is located. 36/ Foundations are only required to make the return available for 180 days after the notice is published. Finally, foundations are obligated only to make copies available for inspection; they are not required to provide copies.

ii. Access to Returns Through the IRS

There are two ways to access returns through the IRS: in person and by mail. A person, upon advance written request to the IRS, may visit an IRS office to inspect and make copies of any tax-exempt organization's three most recent annual informational returns. A person may also request, in writing, that the IRS send a photocopy by mail.

33/ See Taxpayer Bill of Rights 2, Pub. L. No. 104-168 (1996) (codified as amended at I.R.C. § 6104(e) (1998)).

34/ In April 1999, the IRS revised the disclosure requirements applicable to public charities. See Public Disclosure of Material Relating to Tax-Exempt Organizations, 64 Fed. Reg. 68 (1999) (to be codified at 26 C.F.R. pt. 301 and 602). These revised rules for public charities are described below.

35/ See I.R.C. § 6104(d) (1998); Treas. Reg. § 301.6104(d)-1 (1998).

36/ See I.R.C. § 6104(d) (1998).

3. PUBLIC CHARITIES

All tax-exempt Section 501(c)(3) organizations that do not constitute private foundations are commonly referred to as "public charities." 37/ Public charities differ from private foundations in that one-third or more of the support for a public charity must come from public sources or they must satisfy certain other requirements for qualifying as a public charity (e.g. churches, schools, hospitals). 38/ Public charities are required to file with the IRS annually an informational return either on Form 990 or Form 990-EZ, a short form version available for small charities. 39/

a. Reporting Obligations

Public charities must report, in Form 990 or 990-EZ, the name and address of each donor that contributed a total of $5,000 or more in the previous calendar year to the charity. The charity must also report the total amount of the contributions that it received from each such donor. 40/ Unlike private foundations, public charities are not obligated to make the portion of Form 990 or Form 990-EZ containing this donor information available to the public. 41/

Public charities, like private foundations, must report all grants and contributions made each year (including those grants and contributions made to other tax-exempt organizations), regardless of the amount of any single distribution. Specifically, they must

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37/ See Bruce R. Hopkins, The Law of Tax-Exempt Organizations 254 (7th ed., John Wiley & Sons, Inc.) (1997).

38/ See I.R.C. § 509(a)(2)(A) (1998). Sources of funding will be considered from the public if they are received from: (1) the government; (2) the general public (directly or indirectly); or (3) a combination of these sources. See Publication 557, Tax-Exempt Status for Your Organization.

39/ The major difference between Form 990 and Form 990-EZ is that Form 990 requires more detailed information on the types of charitable activities conducted and a more complete description of the dollar value of the sources of revenue, expenses and assets. Some public charities are exempt from such filing requirements.

40/ See Instructions for Form 990, Line 1d. In calculating whether a series of contributions from a person or entity meet or exceed the $5,000 contribution threshold, a tax-exempt organization need only include those contributions from the respective donor that are at least $1,000 or more.

41/ See id.

report the name and address of each recipient and the amount of each donation that they made. 42/

b. Public Access to the Returns Filed By Public Charities

Section 6104(e) of the Code provides that the public have access to the three most recent annual informational returns for all tax-exempt organizations, including public charities. As discussed above, however, public charities are not obligated to make the portion of Form 990 or Form 990-EZ containing donor information available to the public.

i. Access to Returns Through The Public Charity

In 1996, Congress enacted the Taxpayer Bill of Rights 2, which required public charities to provide copies of their informational returns to persons who request them in writing or in person. 43/ The Act was intended to remedy problems with existing disclosure practices. 44/ By increasing public access, Congress hoped to "enhance the oversight and public accountability of non-profit organizations" and increase public awareness. 45/ Without public access to information, "contributors [to public charities] may never learn exactly how their donations are being spent." 46/

On April 9, 1999, the IRS announced changes in the rules that apply to public charities. 47/ Under the new rules, any person, in person or upon written request, can either:

42/ See Instructions for Form 990, Lines 22-23.

43/ See Taxpayer Bill of Rights 2, Pub. L. No. 104-168 (1996) (codified as amended at I.R.C. § 6104(e)(1998)).

44/ Interested persons previously had to travel to the charity's principal office to inspect the informational returns. See Increased Compliance by Tax-Exempt Organizations: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 103rd Cong. 12 (1994).

45/ See Section 501 Tax-Exempt Organizations: Hearing on Activities of Public Charities Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 103rd Cong. 41 (1993), reprinted in 93 Tax Notes Today 164-29 (1993).

46/ Id.

47/ See Public Disclosure of Material Relating to Tax-Exempt Organizations, 64 Fed. Reg. 17,279 (1999) (to be codified at 26 C.F.R. pt. 301 and 602). These new rules are effective June 8, 1999.

(1) obtain a copy of the three most recent informational returns (although the public charity is not required to permit inspection of its list of donors) at the principal office of the public charity; or
(2) request that the public charity send a photocopy of the returns (although the public charity is not required to make a copy of its list of donors) by mail. 48/

Alternatively, a public charity is relieved of its duty to provide copies of its three most recent informational returns if this information is made "widely available" to the general public in a format approved by the IRS. 49/ A public charity can make its application for tax-exemption and/or an informational return widely available by either:

(1) posting the returns on a World Wide Web page that the tax-exempt organization establishes and maintains; or
(2) having the returns posted, as part of a database of similar documents of other tax-exempt organizations. 50/

The returns must be posted "in a format that, when accessed, downloaded, viewed and printed in hard copy, exactly reproduces the image of the application for tax-exemption or annual informational return." 51/

ii. Access to Returns Through the IRS

Persons can access a public charity's three most recent annual informational returns and determination letter through the IRS in person and by mail.

B. FEDERAL SECURITIES AND STATE REQUIREMENTS FOR DISCLOSURE OF CHARITABLE CONTRIBUTIONS

1. DISCLOSURE REQUIREMENTS UNDER THE FEDERAL SECURITIES LAWS

Currently, the federal securities laws do not specifically require public companies or mutual funds to disclose their charitable contributions. One provision of the Commission's

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48/ The Taxpayer Bill of Rights 2, enacted July 30, 1996, amended § 6104(e) by adding additional disclosure requirements for tax-exempt organizations (other than private foundations).

49/ Public Disclosure of Material Relating to Tax-Exempt Organizations, 64 Fed. Reg. 17,279, 17,283 (1999) (to be codified at 26 C.F.R. pt. 301 and 602).

50/ See id.

51/ Id.

executive compensation disclosure rules requires companies to disclose charitable awards made in the name of a director (sometimes referred to as director legacy awards). 52/ The Commission has previously described these programs as ones in which:

> registrants typically agree to make a future donation to one or more charitable institutions in a participating directors name, payable by the registrant upon the director's death or retirement, or some other designated event. Funding vehicles for these programs commonly take the form of corporate owned insurance policies on the lives of participating directors. 53/

The Commission decided to require disclosure because these awards relate to the director's service on the board, the premiums can be considerable, and the awards "are material in assessing the relationship of directors to the registrant." 54/

2. DISCLOSURE REQUIREMENTS UNDER STATE LAW

States generally do not require corporations to disclose their charitable contributions. 55/ But foundations are subject to state reporting and disclosure requirements.

Federal law requires that private foundations that file Form 990-PF with the IRS must also deliver a copy of their annual Form 990-PF to the attorney general of any state in which the foundation was created, is registered, or is principally located. 56/

52/ Regulation S-K, Item 402(g)(2) requires that companies disclose other arrangements pursuant to which directors are compensated for any service provided as a director. The Commission, in adopting this rule, stated that it applied to "charitable award or legacy arrangements." See SEC Release No. 33-6962, 52 SEC Docket 2980, 2991-92 (October 16, 1992).

53/ Id. at 2991.

54/ Id.

55/ See Faith Stevelman Kahn, Legislatures, Courts and the SEC: Reflections on Silence and Power in Corporate and Securities Law, 41 N.Y. Law School L. Rev. 1107, 1108, 1120 (1997).

56/ See Instructions for Form 990-PF, Gen. Instruction G, at 4. Generally, states require private foundations and other charitable organizations to register with them if they either solicit funds or hold assets in the state.

In addition to the federal reporting requirements, private foundations are subject to state law reporting requirements. 57/ Nineteen states require charitable trusts to be registered with the state. 58/ Generally, these charitable trusts are also private foundations. 59/ The 19 states which require registration of charitable trusts, or private foundations, also require annual reporting. 60/ Private foundations can almost always satisfy state law reporting requirements by filing an IRS Form 990-PF with the state. 61/ In the 19 states which require annual reporting by private foundations, state law also generally requires that the annual reports be made publicly available. 62/

C. DISCLOSURE OF CONFLICTS OF INTEREST UNDER THE FEDERAL SECURITIES LAWS

The Commission's rules contain several provisions requiring companies to disclose various forms of conflicts of interest. The concept in the federal securities laws of requiring companies to disclose conflicts of interest dates back to 1942. 63/ Item 404(a) of

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57/ See Developments in the Law: Non-Profit Corporations, 105 Harv. L. Rev. 1578 (1992).

58/ In 1996, the National Association of Attorneys General (NAAG) conducted a survey of state requirements. National Association of State Charity Officials, Nat'l Assoc. of Attys. Gen., Report On NAAG/NASCO Charities Survey, at 1-4 (1996).

59/ Telephone Interviews with David Ormstedt, Assistant Attorney General for the State of Connecticut and former President, National Association of State Charity Officials (May 25 and 27, 1999) ("Ormstedt Interviews").

60/ Id.

61/ Id.

62/ Id. For instance, New York requires all nonprofit organizations to file annual financial reports with the State Attorney General's Office. New York will accept the IRS Form 990 and 990-PF to satisfy the state requirement. In addition, the public has full access to inspect or copy these records. See Report: To Profit or Not-to-Profit: An Examination of Executive Compensation in Not-for-Profit Organizations Contacting with New York City, 25 Fordham Urb. L.J. 471, 479 n.16 (1998). Assistant Attorney General David Ormstedt stated that, at least with respect to Connecticut, there is almost no demand for the private foundation while there is significant public demand for returns of public charities.

63/ Letters of Director of Corporation Finance Division of the Securities and Exchange (continued...)

Regulation S-K requires that companies "describe briefly" significant transactions between the companies and entities in which directors, executive officers, nominees for director, beneficial owners of more than five percent of the company's voting securities and/or immediate family members of any of the foregoing have an interest. Item 404(b) requires companies to disclose information about business relationships between the company and other business or professional entities in which a director, or director-nominee of the company, was either an executive officer or a record or beneficial owner of more than ten percent of the voting stock of the other entity. Item 404(c) requires companies to disclose information about the indebtedness to the company of management, immediate family members and others. Item 404(d) requires companies that have been organized in the past five years to disclose transactions with promoters.

Since the Commission began requiring disclosure of conflicts of interest, however, it has limited disclosure to material, significant transactions. For instance, Item 404(a) of Regulation S-K requires disclosure of conflicts of interest but only if two conditions are satisfied. First, the value of the transaction must exceed $60,000. This threshold was intended by the Commission to be a *de minimis* threshold and was last adjusted in 1982. 64/ Second, the individual must have an interest in the transaction that is material. The interest can be direct or indirect. The materiality of an interest is to be determined "on the basis of the significance of the information to investors in light of all the circumstances of the particular case." 65/

63/(...continued)
Commission, Interpretation of Certain Proxy Rules, SEC Release No. 34-3385 SEC Docket 41-44 (December 18, 1942). In its original form, Item 5(H) of Schedule 14A required issuers to "[d]escribe briefly any interest, direct or indirect, of each person who has acted as a director of the issuer during the past year and each person nominated for election as a director and any associates of such director or nominee in any transaction during the past year or in any proposed transaction to which the issuer or any subsidiary was or is to be a party. No reference need be made to immaterial and insignificant transactions."

64/ When Items 402(f) and 6(b) were combined to form the current version of Item 404, the *de minimis* threshold set forth in Instruction 2C to Item 402(f) was $50,000. SEC Release No. 33-6416 (July 20, 1982). In response to commenters' suggestions, the threshold was later raised to $60,000. SEC Release No. 33-6441, 47 FR 55661 (December 13, 1982). Item 404(c), which requires disclosure of indebtedness to the company, also uses a threshold of $60,000.

65/ In determining the significance of information to investors, Item 404(a) sets forth the following factors, among others, to be considered:
1) the importance of the interest to the person having the interest;
2) the relationship of the parties to the transaction with each other: and
3) the amount involved in the transactions.

Since the first conflict of interest provision was adopted in 1942, the Commission has regarded "the fact that a director of the issuer is also a director of another company [as] not enough of itself to establish the materiality of his interest in transactions between the two companies." 66/

In Item 404(a), the Commission has deemed a transaction to be *per se* immaterial (and therefore not subject to the disclosure requirement) where a person's interest in a transaction arises only from the individual's position as director of an entity which is a party to the transaction with the company. 67/ In adopting Item 404(b), the Commission rejected a proposal which would have mandated disclosure of business relationships where the only connection between the registrant and another entity was a person who served as a director of both entities but was not an employee of either. Commenters suggested that directors generally are unaware of transactions between the registrant and the other entity of which they are director, and thus they are unlikely to be subject to conflicts of interest due to their relationships. The Commission agreed with this comment and stated, "[t]he Commission believes that the need for disclosure of the existence of business dealings between entities with common directors does not justify the effort involved in making this determination." 68/ The Commission noted that this was consistent with Item 404(a) which also excluded disclosure based solely on such relationships. 69/

Finally, the conflict of interest provisions of Regulation S-K and those contained in H.R. 887 apply to different people. Companies that currently have procedures for monitoring conflicts of interest would find compliance with additional rules easier if they are similar to current rules. Item 401(d) applies to the following persons: (1) a director; (2) an executive officer; or (3) a person nominated or chosen [by the registrant] to become a director or executive officer. Item 404(a) applies to transactions involving the following persons: (1) a director; (2) an executive officer; (3) a nominee for directorship; (4) a beneficial owner of more than five percent of the registrant's voting securities; and (5) an immediate family member of any of the foregoing. 70/ Exhibit C contains comparisons of the persons to whom H.R. 887 and Items 401(d) and 404(a) of Regulation S-K apply.

66/ SEC Release No. 34-3385 SEC Docket 41-44 (December 18, 1942).

67/ See Item 404(a), Instruction 8(A).

68/ SEC Release No. 33-6416, 47 FR 31394 (July 20, 1982).

69/ See id.

70/ The term "immediate family" as defined by Item 404(a) includes: 1) spouse; 2) parents; 3) children; 4) siblings; 5) mothers and fathers-in-law; 6) sons and daughters-in-law; and 7) brothers and sisters-in-law.

VII. CURRENT VOLUNTARY DISCLOSURE OF CHARITABLE CONTRIBUTIONS

A. INTRODUCTION

In their comment letters on H.R. 944 and H.R. 945, some companies stated their belief that many or most companies voluntarily disclose their contributions. For example, BankAmerica stated, "[m]any companies, including BAC [BankAmerica Corporation], already make appropriate information available to interested shareholders." 71/ Intel Corporation wrote, "[m]ost companies, including our own, currently publish a list of all significant charitable donations in the form of an annual report...[which is] readily available upon the request of any person, including shareholders." 72/ These statements were echoed by other commenters.

In contrast, one professor who has recently studied corporate charitable contributions characterized the disclosure in annual reports as "anecdotal." 73/ The National Committee for Responsive Philanthropy had difficulties obtaining information from companies regarding charitable donations made by either the companies or their foundations. 74/ The National Committee asked 30 companies for their guidelines on charitable grants and lists of grant recipients. Only two of the 30 provided all the information requested. One company provided partial information. Four of the 30 companies provided only general guidelines and did not disclose any donations. In 1996, the National Committee asked 174 corporations with foundations to provide "very basic information on their grantmaking programs." Only 47 of the 174 corporations (27 percent of those asked) responded with specific data.

In connection with this report, the Commission staff studied current practices of two groups of companies in disclosing their charitable contributions. The first group consisted of all companies listed in the 1996 "Fortune 100," as ranked by Fortune magazine, which was

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71/ Comment Letter from Cheryl Sorokin, Executive Vice President, BankAmerica Corporation, November 12, 1997.

72/ Comment Letter from Peter Broffman, Manager, Corporate K-12 Donations, Intel Corporation, and Executive Director, Intel Foundation, November 18, 1997.

73/ Faith Stevelman Kahn, Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy, 44 U.C.L.A. L. Rev. 579, 583 (1997).

74/ See Comment Letter from Steve Paprocki, the National Committee for Responsive Philanthropy, November 12, 1997.

published in April 1997. 75/ The companies included in the Fortune 100 are listed on Exhibit D. The Commission staff decided to study the Fortune 100 because these companies had the most resources to make charitable donations and to provide the information to shareholders.

In an attempt to survey a group more representative of all public companies that would be subject to H.R. 887, the Commission staff also surveyed a second group of companies. These 20 companies were randomly selected by a computer program from all public companies (the "Random 20"). Half of the Random 20 companies earned more than $125 million in revenues in 1996. 76/

With regard to each of the 111 companies surveyed (91 of the Fortune 100 and 20 random companies), the Commission staff sought information on charitable contributions from the following three sources:

(1) glossy annual reports;
(2) contribution reports of the corporation or the corporation's foundation; and
(3) company websites.

B. GLOSSY ANNUAL REPORTS OF FORTUNE 100 COMPANIES

1. DISCUSSION OF CHARITABLE CONTRIBUTIONS

Thirty-two of the Fortune 100 companies discuss, in their glossy annual reports, charitable contributions made by the company, their foundation, or both. Companies in the top half of the Fortune 100 were more likely to have some discussion of charitable contributions than companies in the bottom half. While the total number of pages in the annual reports of those 32 companies range from 14 to 124 pages, the amount of space dedicated to a discussion of charitable contributions ranges from two lines to over three

75/ Companies are ranked on the basis of revenues. Seven of the Fortune 100 companies are not public and two have merged into other Fortune 100 companies. Accordingly, for purposes of most of our analysis, only 91 of the Fortune 100 companies are relevant.

76/ The top two companies had revenues of more than $1 billion each.

pages. 77/ Twenty-seven of the 32 companies that discuss contributions dedicate at least a half of a page to the discussion.

2. DISCLOSURE OF CHARITABLE CONTRIBUTIONS

None of the Fortune 100 companies discloses each of its contributions in its glossy annual report. Twelve of the Fortune 100 disclose the total dollar amount that they contributed to charity in the previous year. 78/ To the extent that companies disclose any particular recipients of donations, they only give examples of their contributions. 79/

3. OTHER DISCLOSURE OF CHARITABLE CONTRIBUTIONS

Companies sometimes publish reports, of varying detail, on the charitable contributions of the company and/or the corporate foundation. Twenty-three of the Fortune 100 companies indicate in their glossy annual reports that shareholders may request a report on charitable contributions made by the company or a foundation established by the company. Specifically, 12 companies offer only a corporate contribution report, 10 companies offer only a foundation contribution report, and one company offers both a corporate and foundation contribution report. 80/

C. GLOSSY ANNUAL REPORTS OF RANDOM 20 COMPANIES

Only one of the Random 20 companies discusses charitable contributions in its glossy annual report. In its 1996 annual report, that company dedicated one page to discussing its corporate contributions. It does not disclose, in the glossy annual report, the total dollar amount of all of its charitable contributions. While it does name several organizations receiving charitable donations, there are no corresponding dollar amounts of any contributions. Furthermore, it does not make any reference to a charitable contribution report which might be made available. In fact, none of the Random 20 glossy annual reports

77/ Based upon an order of least-squares regression analysis, the Commission staff found that there is no correlation or relationship between the total number of pages in an annual report of the Fortune 100 companies and the number of pages dedicated to discussing charitable contributions. As the number of pages in these annual reports increase, the number of pages dedicated to discussing charitable contributions do not necessarily also increase.

78/ Of the 12 companies, seven also disclose the total amount on their websites.

79/ Twenty-seven of the Fortune 100 companies name one or more charities receiving contributions, with 21 companies disclosing the amount of one or more contributions.

80/ In addition, one company provides this information on its website.

indicated that the company had reports available on the contributions of the company or its respective foundation.

D. CONTRIBUTION REPORTS OF THE FORTUNE 100

1. OBTAINING THE CONTRIBUTION REPORTS

A total of 23 of the 1996 Fortune 100 companies include a statement in their annual report that either a corporate charitable contribution report or a foundation charitable contribution report is available to those who request it. In some cases, it was relatively easy for the Commission staff to obtain the report. In many cases, however, the Commission staff found it difficult to obtain these reports. The Commission staff ultimately received 18 contribution reports: six reports discussing corporate contributions; seven reports discussing foundation contributions; and five reports discussing both corporate and foundation contributions.

2. DISCLOSURE IN THE CORPORATE CONTRIBUTION REPORTS

The 11 reports that discuss corporate contributions range in length from nine pages to 36 pages. 81/ Ten reports disclose the total amount contributed to charity. Seven of the 11 reports disclose, by category, the total amount contributed. Four of the 11 reports disclose the names of all charities to which contributions were made but not the amounts of each contribution. Three of the 11 reports disclose both the names of all charities to which they made contributions and the amounts of each contribution. 82/ Nine reports give the guidelines for determining contributions.

3. DISCLOSURE IN THE FOUNDATION CONTRIBUTION REPORTS

The 12 reports that discuss contributions made by corporate foundations range in length from 12 pages to 53 pages. 83/ Eleven of the 12 reports disclose the total amount contributed by each foundation to charity. Ten of the 11 reports also disclose how that amount was distributed to various categories of charitable organizations. Seven of the 12 reports disclose the names of all charities to which contributions were made and the amounts

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81/ Five of the 11 contribution reports discuss charitable contributions made by both the respective company and its corporate foundation. One of the reports is a "Company Profile" that includes information about charitable contributions and other issues.

82/ One of those only reports contributions above $10,000.

83/ Five of the 12 contribution reports discuss charitable contributions made by both the company and its corporate foundation.

of each contribution. 84/ Nine of the 12 reports give the guidelines for determining contributions. In addition, three reports discuss international contributions, with two of them disclosing the names and amount of each international contribution.

E. WEBSITES OF FORTUNE 100 COMPANIES

1. NUMBER OF FORTUNE 100 COMPANIES THAT DISCLOSE INFORMATION

Seventy-two of the Fortune 100 companies discuss on their websites charitable contributions made by the corporation, their foundations, or both. 85/ Twenty-six companies discuss only corporate contributions. Seventeen companies discuss only foundation contributions. Twenty-nine companies discuss both corporate and foundation contributions.

Disclosure on the World Wide Web is evenly distributed among companies in the Fortune 100. Thirty-eight of the top 50 companies discuss contributions on their websites, while 34 of the second 50 companies discuss contributions on their websites. This may reflect the relative ease and low cost of disclosing information on the World Wide Web.

The extent of disclosure made by corporations and foundations ranges from five lines to over ten pages. Twenty-nine of the 71 companies that discuss contributions dedicate at least ten pages to the discussion.

2. DISCLOSURE MADE BY COMPANIES

Seven companies disclose the total amount contributed only by the company to charities. Fifteen companies disclose the total amount contributed only by a foundation. Thirteen companies disclose the total amount contributed by both the company and the foundation.

One company lists all the names of recipients of contributions made by the company and the amounts of each contribution. Six companies list the names of recipients of contributions made by their foundation and the amounts of each contribution. One company lists all the names of recipients of contributions made by both the company and its foundation and the amounts of each contribution.

84/ Three of the seven also disclose this information on the website.

85/ Of the public Fortune 100 companies, only one company does not have a website.

3. ADDITIONAL DISCLOSURE

Of the 72 companies that discuss contributions on their websites, three companies offer a corporate contribution report, seven offer a foundation contribution report, and two offer both a corporate and foundation contribution report.

None of the 22 Fortune 100 companies that do not discuss charitable contributions on their websites tells shareholders how to obtain either a corporate or foundation contribution report.

F. WEBSITES OF RANDOM 20 COMPANIES

The Commission staff located websites for 13 of the Random 20 companies. 86/ Only one of those 13 companies discusses charitable contributions made by the company or the company's foundation.

VIII. SHAREHOLDER AND CORPORATE VIEWS ON DISCLOSURE

A. SHAREHOLDER PROPOSALS RELATING TO CHARITABLE CONTRIBUTIONS

One indicator of the strength of shareholder interest in disclosure of charitable contributions is the extent to which shareholders have submitted and supported shareholder proposals on the subject.

1. BACKGROUND ON SHAREHOLDERS' RIGHTS TO SUBMIT PROPOSALS

SEC rules permit holders with $2,000 worth of stock (held for at least one year) to submit proposals for the company to publish in its proxy statement. There are 13 exceptions, the most relevant of which permits companies to exclude proposals addressing matters of "ordinary business." 87/ In 1976, the Commission stated that "matters that are mundane in nature and do not involve any substantial policy or other considerations" would

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86/ Six companies do not have websites. One company is in the process of establishing its website.

87/ Rule 14a-8(i)(7) permits an issuer to omit a proposal that "deals with a matter relating to the company's ordinary business operations." One appellate panel explained the rationale of Rule 14a-8(i)(7) is that "management cannot exercise its specialized talents effectively if corporate investors assert the power to dictate the minutiae of daily business decisions." Medical Committee For Human Rights v. Securities and Exchange Commission, 432 F.2d 659, 678-79 (D.C. Cir. 1970), vacated as moot, 404 U.S. 403 (1972).

be considered to be ordinary business and, accordingly, could be omitted. 88/ On the other hand, "proposals that have major implications" or that address "matters which have significant policy, economic or other implications inherent in them", would not be considered ordinary business, and, therefore, could not be omitted on that basis. 89/

2. SHAREHOLDER PROPOSALS RELATING TO CHARITABLE CONTRIBUTIONS

On the basis of the ordinary business exception, the Commission staff has taken the position that companies may omit shareholder proposals that would direct a company to make a charitable contribution or refrain from making a contribution to specific charities or specific types or groups of charities. 90/ On the other hand, the Commission staff does not believe that a company may omit any proposal directed to a company's general policies regarding charitable donations because the Commission does not consider such a proposal to involve the ordinary business of the company. 91/

During the past seven years, there have been a few shareholder proposals submitted to shareholders that have involved disclosure of charitable contributions. Each year from 1992 to 1996, a shareholder proposal was submitted to NYNEX (which recently merged into Bell Atlantic) that recommended that NYNEX disclose in its annual report all of its charitable contributions. That proposal was voted upon each year from 1992 through 1996 and received from 10.1 percent to 15.8 percent of the shareholder vote.

88/ SEC Release No. 34-12999, Fed. Sec. L. Rep. Decisions 1976-77, 87123 at 87,131 November 22, 1976.

89/ Id.

90/ See KMart Corporation, SEC No-Action Letter [1998 SEC No-Act 350] (March 4, 1998) (the staff concurred in KMart's view that KMart could omit a proposal to eliminate charitable contributions to organizations that perform abortions; the staff's position was that the decision to make specific contributions constituted "ordinary business"), and SCE Corp., SEC No-Action Letter [1992 SEC No-Act. LEXIS 214] (February 20, 1992) (the staff concurred in SCE's view that SCE could omit a proposal requesting that SCE make contributions to improve fisheries and wildlife habitats; the staff's position was that the decision to make specific contributions constitutes "ordinary business").

91/ See General Mills, Inc., SEC No-Action Letter [1998 SEC No-Act. LEXIS 662] (June 25, 1998) (the staff declined to concur in General Mills' view that General Mills could omit a proposal requesting it refrain from making any charitable contributions and that money for that purpose be distributed to the shareholders; the staff's position was that the proposal does not involve "ordinary business").

In 1994, shareholders of New England Electric considered a shareholder proposal that recommended that the directors publish, in the proxy statement, the company's standards for making tax deductible contributions. In addition, the proxy statement would have included a list of recipients to which the board of directors intended to make contributions in the ensuing calendar year and an explanation as to how each donation complied with the company's standards. The proposal received the support of 16.4 percent of the shareholders.

In 1997, the same proposal was submitted to J.P. Morgan. It was omitted from the company's proxy statement because J.P. Morgan had substantially implemented the proposal. 92/

In 1998, only four proposals, out of a total of 359 93/ upon which there was a vote, concerned charitable contributions. 94/ Two of these proposals were submitted to the shareholders of the Advest Group Inc. and Bradley Real Estate. Both proposals were defeated, garnering 16.2 percent and 8.3 percent of the shareholder vote, respectively. 95/ In addition, two proposals recommended that the Aluminum Company of America and General Mills refrain from all corporate giving and distribute the funds (that would have been donated to charity) to shareholders in the form of a cash dividend. These two proposals were also defeated, garnering 1.8 percent and 3.9 percent of the shareholder vote, respectively. 96/

In 1999 annual meetings, none of the 422 proposals likely to be submitted for a vote relates to charitable contributions. 97/

3. PROPOSALS RELATING TO THE ROLE OF SHAREHOLDERS

In recent years, shareholders of a few companies submitted proposals that would have given shareholders a role in determining who receives contributions from the company.

92/ Rule 14a-8(i)(10) provides a basis for omitting proposals that the company has "already substantially implemented."

93/ Of the 359 shareholder proposals, 102 concerned social policy issues.

94/ Investor Responsibility Research Ctr., Summary of 1998 U.S. Shareholder Resolutions February 3, 1999, 1, 3.

95/ Telephone Interview with Meg Voorhes, Investor Responsibility Research Center (May 24, 1999).

96/ Id.

97/ Id.

None of these proposals, however, was supported by more than seven percent of a company's shareholders. 98/

B. THE BERKSHIRE HATHAWAY PROGRAM AND THE VIEWS OF WARREN BUFFETT

1. THE BERKSHIRE HATHAWAY PROGRAM

One company that is known to have a creative approach to charitable giving is Berkshire Hathaway, Inc. Since 1981, Berkshire Hathaway has permitted certain classes of its shareholders to vote on charitable contributions. 99/ Each shareholder participates on a basis proportionate to the number of shares that it owns or controls.

2. BERKSHIRE HATHAWAY'S DISCLOSURE OF CHARITABLE CONTRIBUTIONS

Berkshire Hathaway provides information to shareholders regarding its charitable giving program in its annual report. Berkshire Hathaway's disclosure, however, only discloses the total dollar amount of shareholder directed contributions and the total number of charities to which contributions were made. The company does not disclose the names of the recipients or the dollar amount contributed to each. Berkshire Hathaway does not disclose, even in the aggregate, the amount of discretionary contributions that management makes to charity or the names of the recipients.

3. MR. BUFFETT'S VIEWS ON DISCLOSURE

Mr. Buffett commented on the bills introduced in the 105th Congress. Many of his views are also applicable to H.R. 887. Mr. Buffett states that "managers should be accountable for the charitable dollars they dispense." He believes that companies do make contributions that "psychically reward the CEO but do little for the corporation or its owners." "In a relatively small number of cases," he believes that companies make contributions to " 'pet' charities of the CEO, his family, or certain board members."

98/ The highest support of these proposals came in 1992, when 6.7 percent of the shareholders of the Bank of Boston and 5.9 percent of the shareholders of New England Electric supported shareholder proposals that recommended that each shareholder be able to designate (on a proportionate basis) recipients of charitable contributions from the respective company. In 1997, 4.3 percent of the shareholders of Merck supported a similar proposal.

99/ Berkshire Hathaway's program excludes two major groups of shareholders: Class B shareholders and all shareholders who hold shares in "street name."

Mr. Buffett would not object to Berkshire Hathaway disclosing the names of recipients of its charitable donations. However, he believes that, due to the number of recipients at Berkshire Hathaway (almost 4,000), it would be "more useful in giving shareholders a sense of where the money is going," to disclose the amount of money donated to categories of recipients instead of each individual recipient.

Mr. Buffet favors requiring public companies to disclose any "important contributions" that they make. He suggests that companies be required to disclose the 25 largest cash contributions above $2,500. He believes that any disclosure requirements should apply to the company's private foundation, if one exists. He favors this limited disclosure to keep administrative costs low.

Mr. Buffett appears to favor limiting disclosure to cash contributions for the following reasons:

(1) shareholders are interested primarily in cash contributions;
(2) abuses are likely to involve cash contributions; and
(3) quantifying non-cash contributions may be more burdensome for companies.

4. MR. BUFFETT'S VIEWS ON THE COSTS AND BENEFITS OF LIMITED DISCLOSURE

In Mr. Buffett's estimation, the cost of requiring disclosure of only the top 25 contributions would be "negligible." He notes that "the information is already collected for the tax return of the corporation or its philanthropic foundation." "The information is already there, and it is a simple matter to tabulate and present it."

Mr. Buffett does not anticipate that requiring disclosure would cause companies to reduce the amount of money that they contribute to charities. He predicts that there would be a "minor effect" on the types of charitable organizations that receive corporate contributions.

Mr. Buffett believes that the benefits of limited disclosure "far outweigh" the costs. "The main benefit to the proposal — and not an inconsiderable one in my view — is that the owners of a business will know what managers are doing with their money." Another benefit is that companies may alter their practices. "The press would scrutinize such lists [of contributions] and some CEOs and their boards might become more circumspect in their behavior." Mr. Buffett concludes that "corporate giving will be more rational if disclosure is required." Mr. Buffett thinks that H.R. 887 is "in the public interest." 100/

100/ Letter from Warren E. Buffett, Chairman, Berkshire Hathaway, Inc. to Brian J. Lane, Director, Division of Corporation Finance, SEC, May 17, 1999.

C. PUBLIC COMMENTS ON PREVIOUS BILL - - H.R. 944

On October 30, 1997, the Commission asked the public for information regarding the costs and benefits, as well as the feasibility of H.R. 944 and H.R. 945. The request yielded comment letters from 193 sources. More than half of the letters (108) came from companies and corporate foundations, and an additional nine letters came from corporate associations. Comments were also received from nine academics, 11 charitable associations, 26 charitable organizations, 28 individuals, one labor union, and one stockholder organization. The Commission staff reviewed each of the comment letters received in connection with H.R. 944. Although some commenters supported the bill, the vast majority opposed it. While many of the most significant concerns raised about H.R. 944 have been addressed by Congressman Gillmor in H.R. 887, some of the comments on H.R. 944 continue to have relevance to H.R. 887.

1. BENEFITS OF DISCLOSURE

Several commenters on H.R. 944 indicated that there was a need to mandate disclosure because information on corporate charitable contributions is not readily available, 101/ despite the fact that it was of relevance and interest to shareholders. 102/ Shareholders complained of having to submit shareholder proposals in order to obtain the information. 103/ The National Committee for Responsive Philanthropy argued "corporations which use their generosity as a sales pitch should be required to back up their sales pitch to those who own the company." 104/

Several commenters questioned whether companies always used corporate funds for appropriate causes. Fund For Stockowners Rights asserted that contribution choices by current boards and management were "arbitrary and capricious...and serve primarily as ego-

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101/ In a 1996 study, the National Committee for Responsive Philanthropy asked 174 companies with foundations for basic information on their charitable giving programs; only 25 percent responded.

102/ Three shareholders were denied disclosure of contributions. According to shareholders, one shareholder request was met with hostility from the company and another with the claim that shareholders are not entitled to the information.

103/ One shareholder claimed that he received information only after submitting such a proposal.

104/ Comment Letter from the National Committee for Responsive Philanthropy, November 12, 1997.

boosting fringe benefits." One comment questioned whether a company should make donations when it was unable to pay shareholders dividends. 105/

Commenters cited the following benefits to companies of requiring disclosure of charitable giving:

(1) improving the quality of corporate contributions;
(2) increasing corporate accountability to shareholders;
(3) giving shareholders another basis on which to assess the judgment of management;
(4) reducing shareholder distrust of management;
(5) lessening speculation that corporate contributions serve the personal interests of the corporate executives; and
(6) serving as a form of advertising for companies which would build goodwill. 106/

In addition, some commenters thought that disclosure would increase public confidence in charities and allow charitable organizations to identify companies that give to similar charities.

.2. COSTS OF DISCLOSURE

A number of commenters asserted that it would be costly for some companies to compile the information. 107/ Letters speculated that disclosure may require additional staff, frustrating corporate efforts to eliminate bureaucracy.

The majority of commenters anticipated that the disclosure of contributions would cause companies to reduce the dollar amount and the number of each company's charitable

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105/ One individual complained that a corporation in which he holds shares donated $750,000 to an educational institution in the name of the company's president but at the time of the donation, the company's earnings could not cover dividends.

106/ See Personal Business; Diary, Soapsuds with a Heart, The New York Times, May 23, 1999, Section 3, at 11.

107/ In its comment letter, California Water Service Company asserted that local managers at each of its 21 operating districts have discretion to make contributions and that the majority of those grants are under $500. See Comment Letter from California Water Service Company, December 11, 1997. In its comment letter, Fortune Brands, Inc., stated that many of its 200 subsidiaries conduct local contributions programs, and due to costs, the corporation only gathers and reports the total sums of this activity. See Comment Letter from Fortune Brands Inc., January 15, 1998.

contributions. 108/ In particular, if disclosure were required, companies might avoid controversial charities, might deduct the costs of disclosure from the amount contributed, and might have an incentive to lower contributions to an amount less than any reporting threshold.

3. OTHER ARGUMENTS AGAINST REQUIRING DISCLOSURE

Some commenters asserted that it was not necessary to mandate disclosure. One commenter stated that companies were already required to report their charitable contributions to the IRS for tax deduction purposes. Some commenters asserted that there were means of requiring disclosure other than passing legislation. For example, commenters stressed that shareholders are able to submit shareholder proposals requesting their company to disclose contributions.

Some commenters claimed that existing corporate practices allowed shareholders access to information regarding charitable contributions. They indicated that companies often sought public recognition of their charitable contributions, and that most charities published the names of corporate contributors in their materials. The Business Roundtable noted that a few companies disclose their contributions in reports that are available on request but "only a very small percentage of shareholders request them." 109/ The majority of commenters agreed that there was little shareholder interest in receiving disclosure of corporate charitable contributions.

Some commenters feared that disclosure would allow shareholders to pursue personal and political agendas rather than business objectives. One company asserted that "public disclosure of all contributions invites criticism by those whose political or personal agendas conflict with the stated objectives and activities of the recipient charities."

Some commenters contended that disclosure of charitable contributions conflicted with existing state law under which charitable contributions are a matter of management's business judgment. The Business Roundtable argued that:

> [f]orcing corporations to report information concerning contributions decisions would be tantamount to asking corporate officials to disclose the status of every new hire or the specifics of each and every marketing expense. Clearly these kinds of decisions should be left to the judgment of corporate management 110/

108/ See Comment Letter from The Business Roundtable, November 20, 1997.

109/ Id.

110/ Id.

They noted that Section 170 of the Code and Generally Accepted Accounting Principles treat charitable contributions as a cost of doing business.

Other commenters claimed the information was immaterial and would not add to the "total mix" of information that investors are likely to consider in making their investment choices. In this regard, one commenter stated:

> absent evidence to the contrary, it is our belief that this information would be of marginal interest to shareholders, and irrelevant to decisions on shareholder action, which is the justification for shareholder disclosure. We believe that embarking on this would put the SEC on a slippery slope, removing any principled boundaries as to what disclosure should be mandated. 111/

Some argued further that corporate management should be accountable to shareholders for the overall effectiveness of the company, but should not be accountable in relatively small areas such as charitable giving.

IX. PATTERNS OF CORPORATE GIVING

Many of the comment letters on H.R. 944 expressed concern that the costs of a company producing a document listing all of its contributions each fiscal year would be prohibitive. In an effort to determine the magnitude of disclosure that might result from any legislation mandating disclosure of charitable contributions, the Commission staff sought to obtain detailed information from the Fortune 100 companies. Specifically, the Commission staff asked each of the companies for a list of all the entities to which it made charitable contributions in 1996 and the amounts of each of those contributions. The Commission staff asked for information regarding both cash and non-cash contributions, domestic and foreign. The staff also asked the companies and/or their foundations for a copy of their Form 990 or Form 990-PF tax return including the list of contributions.

A. DIFFICULTY OF OBTAINING THE INFORMATION

The Commission staff had difficulty in obtaining the desired information from companies and foundations. Five companies sent complete lists of only their direct contributions. 112/ Nine companies or foundations sent complete lists of only their foundation contributions. 113/ Four companies provided complete lists for both their

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111/ Comment Letter from Hormel Foods Corporation, December 2, 1997.

112/ Eight companies sent incomplete lists of their direct contributions.

113/ Ten companies or foundations sent incomplete lists of foundation contributions.

corporate and foundation contributions. Most lists did not include property and other non-cash contributions. Of these 18 entities, only one company provided a complete list of its matching contributions. 114/

B. FINDINGS REGARDING CONTRIBUTIONS BY COMPANIES

The nine companies that provided complete contribution lists made an average of 946 cash contributions in 1996. However, the number of cash contributions made by each of these companies varied widely, ranging from a low of 109 contributions to a high of 2,894 contributions.

Almost 53 percent of the number of cash contributions were contributions of $2,500 or less. However, contributions of $2,500 or less accounted for less than four percent of the total dollar amount contributed by these same companies. In contrast, less than two percent of the number of cash contributions were contributions of $100,000 or more. But these same contributions represented almost 46 percent of the total dollar amount contributed by companies.

Therefore, among the ten companies there is an inverse relationship between the total dollar amount contributed and the total number of contributions. Despite the high percentage of small contributions, companies tended to contribute more dollars through large contributions.

C. FINDINGS REGARDING CONTRIBUTIONS BY FOUNDATIONS

Based on the complete foundation contribution lists obtained by the Commission staff, the 13 foundations made an average of 818 cash contributions. However, the total number of cash contributions made by each foundation varied widely, ranging from a low of 96 contributions to a high of 1,888 contributions.

As with corporate contributions, the largest number of the contributions made by foundations were smaller dollar contributions whereas the most money was given through larger dollar contributions. Contributions of $2,500 or less constituted 41.5 percent of the total number of contributions made by foundations. But these same contributions represented only four percent of the total dollar amount contributed by foundations. In contrast, less than two percent of the total number of contributions were more than $100,000 each, but these same contributions represented 37 percent of the total dollar amount contributed by foundations.

114/ Three of the 18 entities sent incomplete lists of their matching contributions.

D. EXTENT OF DISCLOSURE

Assuming companies use paper measuring 8.5" x 11" with 1" borders (52 lines per page) to print a list of all their contributions, the Commission staff calculated that it would take these ten companies (that provided a complete list of their corporate contributions) between two and 56 pages to disclose their corporate cash gifts, not including employee matching contributions. 115/ Furthermore, based on data from only one of the five companies that provided a list of only corporate contributions, if employee matching contributions made by companies (not the foundations) were included, it would add 56 pages of disclosure. 116/ If contributions from corporate foundations were also included, it would add between two and 36 pages of disclosure.

Using a threshold would have a dramatic impact, at least on the disclosure by the ten companies that provided the Commission staff with data. As noted above, these data are only for cash contributions and do not include employee matching. Even using a threshold of $5,000 would reduce the maximum number of pages of disclosure from 56 to 19 pages. A threshold of $25,000 would reduce the maximum number of pages of disclosure to six pages. Using a threshold of $100,000 would reduce the maximum number of pages of disclosure to two pages.

X. SOME ISSUES CONCERNING H.R. 887

The staff has identified several issues, in addition to those discussed above, regarding H.R. 887. This is not intended to be an exhaustive analysis of all the issues raised by the bill.

A. APPLICATION OF H.R. 887

1. NONPROFIT ORGANIZATIONS

H.R. 887 would apply to contributions to "nonprofit organizations."

a. Different Types of Organizations

This bill could apply to three different types of organizations:

115/ The number of pages needed for disclosure was calculated by taking the number of contributions and then dividing by the number of lines per page (52).

116/ One company that was not among those 18 entities that provided complete lists of corporate or foundation contributions indicated that in 1996 it made over 17,000 employee matching contributions. Disclosure of that information would require 336 pages.

(1) nonprofit organizations;
(2) tax-exempt organizations; and
(3) organizations to which donors make contributions that may be tax deductible from the donor's income.

Whether an organization is a nonprofit organization is determined by state law. Generally, corporations are operated for the benefit of shareholders; profits are passed through to the shareholders. In contrast, nonprofit organizations may not pass on any profits to any person who exercises control over the entity. 117/ The term "nonprofit organization" encompasses a broad spectrum of organizations including traditional charities, social welfare organizations, labor unions, religious groups, political organizations, and foreign organizations.

Whether an organization is a tax exempt organization is determined by federal law. Some nonprofit organizations are also exempt from federal income taxes. Generally, an organization is required to be nonprofit in order to be exempt from federal income tax. To be tax exempt, an organization must be qualified under the Code and must receive a letter from the IRS stating that the organization is tax-exempt. To qualify as a tax-exempt organization, the organization must be of the type listed in section 501 of the Code. 118/ In addition to section 501, section 527 of the Code grants political organizations a tax exemption. 119/

Whether a tax exempt organization is a "qualified organization" whereby a donor may deduct the value of its contribution to the organization is also a matter of federal law. Section 170 of the Code defines which donations are tax deductible. 120/ The largest

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117/ This is called the doctrine of *private inurement*. See Hopkins, supra note 37, at 4.

118/ The largest category of exempt organizations is defined in section 501(c)(3) of the Code. Section 501(c)(3) exempts organizations "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals...." Section 501(c)(3) organizations are prohibited from participating in political campaigns and may not devote a "substantial part" of their activities to attempting to influence legislation.

119/ Section 527 of the Code defines a political organization as "a party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly accepting contributions or making expenditures for an exempt function." Exempt functions include a wide range of activities connected with federal, state, and local elections. See I.R.C. § 527(e)(2) (1998). See also Hopkins, supra note 37, at 363.

120/ See I.R.C. § 170(a)(1) (1998).

category of donations that are deductible by the donor are donations to organizations which are tax-exempt under section 501(c)(3). 121/

Congress has defined the term "charitable organization" for purposes of the Investment Company Act as "an organization described in paragraphs (1) through (5) of section 170 (c) or section 501(c)(3) of the Internal Revenue Code of 1986." 122/ Thus, charitable organizations under the Investment Company Act are generally those organizations which may receive tax deductible contributions under the Code. Congress relied upon this definition in providing an exemption for charitable organizations from the Exchange Act. 123/

Since H.R. 887 uses the term "nonprofit", it would require disclosure of a much broader group of contributions than just those made to charitable organizations.

2. CONTRIBUTIONS V. EXPENSES

H.R. 887 would apply to "contributions" made to nonprofit organizations. The bill does not define the term "contribution." Typically, the term refers to a contribution to a tax exempt organization that is deductible under the Code. The Code does not define the term "contribution," but it does list organizations to which contributions or gifts constitute "charitable contributions" and are therefore eligible for a tax deduction. 124/

The bill would not apply to business expenses. A business expense, such as advertising, may also be tax deductible. A company seeking to avoid disclosure might, under some circumstances, characterize the giving of cash or property to a nonprofit organization as a business expense, as opposed to a charitable contribution.

To qualify as a business expense deductible from gross income, a payment or transfer of property to an organization must:

(1) be made with a "reasonable expectation of a commensurate financial return"; and

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121/ Typically, the donor will request a copy of the IRS determination from the donee which indicates that the donee is an organization which can receive tax-deductible contributions. Additionally, the IRS maintains an extensive listing on its website of organizations which qualify to receive tax-deductible contributions.

122/ § 3(c)(10)(D)(iii) of the Investment Company Act of 1940.

123/ § 3(e) of the Exchange Act.

124/ I.R.C. § 170(c) (1998).

(2) have "a direct relationship to the taxpayer's trade or business." 125/

3. CORPORATE FOUNDATIONS

As drafted, H.R. 887 does not apply to corporate foundations. As discussed above, companies may make a significant portion of their charitable contributions through their own foundations. Companies seeking to avoid the disclosure provisions of the bill could simply make lump sum payments to their foundations and have the foundations make the contributions. Under these circumstances, the company would only be obligated to disclose its contributions to its foundation (assuming that the contribution to the foundation exceeds the reporting threshold). However, the concern is ameliorated in part by the fact that federal tax law imposes some reporting obligations upon private foundations.

4. MATCHING CONTRIBUTIONS

H.R. 887 could be interpreted to apply to employee matching contributions as well. Since such contributions are directed by the employee, rather than the company, they may not warrant being disclosed.

5. CONTRIBUTIONS OUTSIDE THE U.S.

H.R. 887 appears to apply to contributions made by U.S. companies to nonprofit organizations outside of the U.S. Should this bill be amended to apply only to tax deductible contributions, contributions by a company directly to foreign nonprofits would not be required to be disclosed since companies are not allowed to claim a tax deduction for such contributions. However, corporate foundations can claim a tax deduction for contributions that they make to nonprofit organizations outside the U.S.

6. CONTRIBUTIONS MADE BY FOREIGN COMPANIES

The bill would apply to all companies registered under Section 12 of the Exchange Act. Since some foreign companies are registered under Section 12, consideration should be given to the application of this legislation to entities subject to foreign laws and customs that may conflict with the purpose of the bill.

7. INVESTMENT COMPANIES

H.R. 887 would apply to investment companies registered under the Investment Company Act. Generally, mutual funds do not make charitable contributions from fund assets. As the Investment Company Institute noted in its comment letter to H.R. 944:

125/ Treas. Reg. § 1.162-15(b) (1998).

> The assets of an investment company belong entirely to its shareholders, who also are entitled (on a pro rata basis) to all of the income and gain from the company's investments. Accordingly, there is no source of funds within an investment company from which management (e.g. the investment adviser to an investment company) could make charitable contributions. 126/

It may be unnecessary, therefore, to subject mutual funds to the disclosure requirements.

B. SECTION 1 OF H.R. 887

1. Covered Persons Under Section 1

The bill applies to the following persons:

(1) directors; 127/
(2) officers; 128/
(3) controlling persons of the company; and 129/
(4) spouses of any of the specified persons.

Although the bill would apply to "officers," it authorizes the Commission to define the term "executive officer." 130/

The bill only applies when one of these persons is also a director or trustee of the recipient nonprofit organization. It would not, for example, require disclosure of gifts from the company to the alma maters of corporate executives or their relatives.

126/ Comment Letter from the Investment Company Institute, November 12, 1997.

127/ The term "director" is defined in Section 3(a)(7) of the Exchange Act.

128/ The term "officer" is defined in Exchange Act Rule 3b-2.

129/ The term "controlling person" is not defined in either the Securities Act or the Exchange Act. The terms "control," "controlling," "controlled by," and "under common control with," however, are defined in Securities Act Rule 405.

130/ The term "executive officer" is defined in Exchange Act Rule 3b-7.

In addition, the bill's approach to conflicts of interest may be different than the Commission's rules regarding conflicts of interest. 131/ Since companies are not required under current Commission rules to identify conflicts of interest in connection with charitable giving, many companies may not have in place mechanisms to monitor such transactions.

2. Timing of Conflict of Interest

Section 1 of H.R. 887 requires disclosure of contributions that were made to an organization of which a director, officer, controlling person, or their spouse "was" a director or trustee. It is unclear from the language when the conflict must exist to trigger the disclosure obligations. Possible interpretations could include that the conflict had to exist:

(1) at the time that the decision to make the contribution was reached;
(2) at the time that the contribution was delivered or executed;
(3) anytime during the company's previous fiscal year; or
(4) anytime before the contribution was made.

C. SECTION 2 OF H.R. 887

1. THE TOTAL AMOUNT OF CONTRIBUTIONS

Section 2 of H.R. 887 specifically grants the Commission the authority to "designate" the "format" in which the total amount of contributions will be made available. The bill does not specify to whom such information should be made available. It is assumed that the intent is to make the information available to shareholders and, perhaps, to the public generally. This could be done in a Commission filing or perhaps, on the company's website. Moreover, as discussed above, the IRS recently adopted rules applicable to public charities that permit public charities to post information on a website as a means of satisfying their disclosure obligations. 132/

131/ In particular, the bill would apply to all officers while Items 401(d) and 404(a) of Regulation S-K apply to all conflict of interests involving executive officers. The bill would apply to controlling persons while Item 404(a) applies to a beneficial owner of more than five percent of the company's voting stock. Moreover, the Commission, in adopting the conflict of interest provisions included in Regulation S-K, has determined not to require disclosure when the conflict is due solely to the fact that a person serves as a director of a company and also serves as a director in another entity.

132/ See Public Disclosure of Material Relating to Tax-Exempt Organizations, 64 Fed. Reg. 68 (1999) (to be codified at 26 C.F.R. pt. 301.6104(d)-4). The IRS provides that as an alternative to providing copies of information on request, a public charity (continued...)

2. INFORMATION REGARDING SPECIFIC CONTRIBUTIONS ABOVE A THRESHOLD

The threshold for disclosing all contributions would presumably be higher than the threshold applicable to contributions involving a conflict of interest. Shareholders would seem to be less concerned about the amount of contributions where there is not a conflict of interest.

3. DISCLOSURE OF CONTRIBUTIONS INVOLVING A CONFLICT OF INTEREST

Since pursuant to Section 1, companies will be disclosing contributions involving a conflict of interest, it appears unnecessary to require duplicate disclosure pursuant to Section 2.

XI. CONCLUSION

The Commission staff believes that the corporate charitable disclosure requirements in H.R. 887 would be feasible in that companies are capable of tracking and disclosing this information to investors. In this regard, the Commission staff notes that many companies already track contributions for tax purposes and that some companies already voluntarily disclose this information to the public. However, the Commission staff has not analyzed the costs and benefits of imposing these additional disclosure requirements on companies. This report does not intend to take a position on any pending legislative proposals nor does it seek to determine whether the subject information is material to investment decisions.

132/(...continued)
can make information "widely available" to the general public by posting it on its World Wide Web page, or posting it, as part of a database of similar documents of other tax-exempt organizations on a world wide web page maintained by another entity. The IRS specifies that the document must be posted "in a format that, when accessed, downloaded, viewed and printed in hard copy, exactly reproduces the image of the application for tax-exemption or annual informational return."

AMERICAN SOCIETY OF
ASCS
CORPORATE SECRETARIES

DAVID WILLIAMSON SMITH
President

October 27, 1999

The Honorable Tom Bliley
Chairman
House Committee on Commerce
2125 Rayburn House Office Building
Washington, DC 20515-6115

The Honorable Michael G. Oxley
Chairman, Subcommittee on Finance and Hazardous Materials
2125 Rayburn House Office Building
Washington, DC 20515-6115

RE: H.R. 887

Dear Congressmen Bliley and Oxley:

Mr. Brent Delmonte has invited a representative of the American Society of Corporate Secretaries to testify concerning H.R. 887 on Friday, October 29, 1999 before the Subcommittee on Finance and Hazardous Materials of the House Committee on Commerce. H.R. 887 presents issues of considerable interest to Corporate Secretaries who are responsible for drafting '34 Act disclosure documents including proxy statements and the annual report on Form 10K.

The ASCS, founded in 1946, is a professional association of more than 4,000 corporate attorneys and other business executives representing over 2,700 corporations, whose major duties include working with corporate boards of directors to improve corporate governance; assuring company compliance with securities regulations; coordinating activities of stockholders, including proxy voting for the annual meeting of shareholders; and administering other activities handled by the Corporate Secretary's Office.

The invitation to testify became known by me only on Monday, October 25th, too short a time to produce an appropriate and available witness to appear before the Subcommittee on Friday, October 29th. However, given the importance of this legislative initiative to our membership and their corporations, and our interest in this topic since H.R. 944 and H.R. 945 were introduced in 1997, we want to weigh in on this subject as it progresses. We would be pleased to offer our views at a future point with more time to prepare.

521 FIFTH AVENUE · NEW YORK, NEW YORK 10175 · TEL: 212-681-2000 · FAX: 212-681-2005

We hope that the following enclosed letters will be helpful n your deliberations:

1) Letter dated November 18, 1997 to Jonathan G. Katz, Secretary, Securities and Exchange Commission, re: File No. S7-26-97; H.R. 944;

2) Letter dated November 18, 1997 to Mr. Katz re: File No. S7-26-97; H.R. 945; and

3) Letter dated May 28, 1999 to the Securities and Exchange Commission, attention: Jonathan Gottlieb re: Rep. Gillmor's revised Charitable Contribution Proposal.

The Society appreciates your interest in our views and stands ready to be helpful in this process in the future.

Please do not hesitate to contact me at any time.

Sincerely yours,

David W. Smith

cc: Mr. Brent Delmonte
316 Ford Office Building
Capital Hill
Washington, DC 20515-6115

American
Society of
Corporate
Secretaries

November 18, 1997

Jonathan G. Katz, Secretary
Securities & Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: File No. S7-26-97
H.R. 944: "To amend the Securities Exchange Act of 1934 to require improved disclosure of corporate charitable contributions, and for other purposes."

Dear Secretary Katz:

This comment letter is submitted on behalf of the Nonprofit Committee of the American Society of Corporate Secretaries (the "Nonprofit Committee"). The Nonprofit Committee is a standing committee of the Society. Our Mission Statement is attached for reference.

This bill is not a good idea. It is unnecessary, inappropriate and would have undesirable effects. The bill would add bulk and complexity to shareholder disclosures at a time when the Commission and companies are trying to simplify and clarify those disclosures.

Shareholders have demonstrated that, as a whole, they are not interested in additional disclosure of corporate charitable contributions. Companies are already saddled with disclosure requirements in this area that few shareholders are interested in. Social Responsibility Reports by many companies are eschewed by most shareholders, even in the face of pro-active efforts by companies to distribute them. Moreover, according to data from the Investors Responsibility Research Center and the American Society of Corporate Secretaries, on every occasion when shareholders have voted on proposals for additional disclosure of charitable contributions, shareholders have <u>overwhelmingly</u> voted <u>against</u> such additional disclosure.

There is no practical reason or policy justification for creating additional disclosure obligations about charitable contributions. Such contributions happen to constitute only one relatively insignificant aspect of companies' overall operations, and do not merit being singled out for special additional disclosure. There are, however, important practical reasons for not requiring a widespread distribution of charitable contribution recipients to all shareholders. Several of our members have made preliminary studies of the cost of printing and distributing such a report, and the numbers are considerable, often nearly equal to the total of the contributions themselves.

This bill is not only bad for companies, but it is also bad for the nonprofit organizations they support. It will jeopardize contributions if companies find themselves subject to vocal criticism from the small number of shareholders who have expressed any concern about this subject. This bill would result in nonprofits diverting funds from their charitable operations to public relations efforts to heighten their image and visibility to companies and their shareholders. The beneficiaries they serve would suffer in the long run from this diversion of scarce resources.

This bill would also result in the diversion of contributions from smaller, regional nonprofits to larger, nationally known nonprofits that are perceived as having "safe" public images. That would be undesirable in this period when local nonprofits are laboring to step into roles abandoned by state and local governments in recent years.

The bill would impose new governmental regulation with no attendant benefits and serious adverse social effects, and the Nonprofit Committee strongly opposes it.

Respectfully,

Walter T. Gangl

Walter T. Gangl, Chair

encls.

WTG/rp

cc: David Smith, President - ASCS
Michael Goodman, Vice President - ASCS

Mission Statement
of
The Nonprofit Committee
of
The American Society of Corporate Secretaries

The Mission of the Nonprofit Committee is to enhance the significant role of nonprofit organizations in our society by providing educational resources to promote effective governance structures, and to stimulate commitment to corporate volunteerism in nonprofit governance by members of the Society.

To carry out its Mission, the Committee will:

- Promote the volunteer ethic within the Society by emphasizing the needs of nonprofit organizations with respect to governance, and facilitating the sharing of resources and mentoring expertise
- Increase representation of nonprofit membership in the Society
- Utilize existent relationships that members of the Society have with nonprofits and encourage development of networking opportunities
- Solicit additional Committee members from a broad geographical spectrum who represent both for profit and nonprofit members of the Society
- Heighten the Chapters' awareness of the Committee's Mission in an effort to develop regional outreach efforts and solicit feedback
- Provide opportunities for collaboration and resource sharing with other national organizations dedicated to preserving the strength of the nonprofit sector.
- Publish or collaborate in the production of materials to assist in the education of nonprofits regarding the broad spectrum of issues necessary for solid corporate governance
- Spearhead the process of enabling the Society to become a valuable resource for federal and state documents to help ensure nonprofit regulatory compliance
- Initiate implementation of a reference source for nonprofits through creation of a web site or "mentoring" list of Society members available for consultation
- Consider coordinating seminars on a national basis or periodic meetings on a regional basis to provide networking opportunities for discussion of issues such as fund development and special event initiatives, board development techniques and problem solving strategies
- Continuously brainstorm to create new opportunities of adding value to nonprofit organizations and the philanthropic endeavors of the for profit sector.

American
Society of
Corporate
Secretaries

November 18, 1997

Jonathan G. Katz, Secretary
Securities & Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: File No. S7-26-97
H.R. 945: "To amend the Securities Exchange Act of 1934 to require corporations to obtain the views of shareholders concerning corporate charitable contributions."

Dear Secretary Katz:

This comment letter is submitted on behalf of the Nonprofit Committee of the American Society of Corporate Secretaries (the "Nonprofit Committee"). The Nonprofit Committee is a standing committee of the Society. Our Mission Statement is attached for reference.

We oppose this bill. We fail to see what problem, if any, is supposed to be remedied by this unprecedented federal government regulation and oversight of charitable contributions by companies. Also, ironically, this bill might result in stifling corporate charitable contributions so soon after three U.S. Presidents have urged greater involvement in volunteerism and charitable contributions.

The process of soliciting shareholder instructions would be expensive, bureaucratic and time consuming. The list of 501(c)(3)-qualified nonprofits to whom contributions could be directed by shareholders would be voluminous and the process of soliciting shareholder designations would be expensive, burdensome and impractical. The typical proxy card on which shareholders vote would not be able to accommodate all 501(c)(3)-qualified organizations.

Even if a sensible process could be developed to garner shareholder "votes" for contributions, it would favor large, well-known nonprofits over smaller, community-based nonprofits. That is bad policy at a time when smaller nonprofits have a bigger impact in our communities and are stepping into the roles formerly filled by state and local governments.

The process proposed would result in competition among nonprofits for shareholders' votes for support. This would have two negative consequences. It would again favor large nonprofits over smaller ones, and it would cause nonprofits to divert large portions of their budgets from their operations to advertising and public relations in order to build name recognition and win shareholder support. It is unwise to foster lobbying of shareholders at the expense of nonprofits' operations.

This bill could substantially reduce corporate support of nonprofits at a time when our country is looking to nonprofits to play larger roles in our society. Shareholders are removed

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from the corporation's operations. They are often unaware of the community good will and tangible returns that their corporations gain from charitable contributions. For example, by supporting higher education in the community where a corporation has operations, it improves the opportunities and qualities of its employees. By supporting childcare facilities, it expands the pool of qualified employees and opens opportunities to women. In both cases, the corporation benefits directly and indirectly from community investments. Shareholders, who are removed from operations, are less likely to appreciate the benefits of such "investments" in the community, and less likely to support such charitable contributions. Shareholders as a whole are more likely to focus on the near-term impact of contributions on earnings-per-share and not appreciate the long-term best interests of the corporation in connection with civic involvement.

It is also notable that the concept of shareholder approval of corporate charitable contributions has been proposed previously in shareholder proposals to several large corporations. In each instance, the concept was overwhelmingly rejected by the Company's shareholders.

This bill is also contrary to principles of corporate law and governance, which dictate that the business operations of a company, including charitable donations, are the responsibility of management. It would be an intrusive, unprecedented shareholder usurpation of management responsibility for operations and forseeably would have serious negative impact on nonprofits. Appropriate protections already exist in corporate governance to protect shareholders against corporate waste.

Moreover, there is no reason for injecting the government, specifically the SEC, into the regulation and oversight of charitable contributions. Any government intrusion in charitable giving is unwise and inappropriate. Frankly, the federal government lacks authority to pre-empt state law on this subject, which would result from this bill's moving responsibility for charitable contributions from management to shareholders.

This bill is reputed to be patterned on the Berkshire-Hathaway model of allowing a few registered shareholders only to vote on its charitable contributions. That model is atypical because Berkshire-Hathaway is primarily an investment company, rather than an operating business. In large part, therefore, it does not have the same interests as an operating company does in contributions that can benefit operations. Moreover, Berkshire-Hathaway's policy in this respect discriminates against its beneficial shareholders, who constitute the substantial majority of almost all other companies' shareholders, and who have as much right to vote as registered shareholders.

The voluntary Berkshire-Hathaway system cannot be adapted to all companies and all shareholders, both registered and beneficial. Attempting to mandate that system and regulate charitable giving through the SEC is unwise and unrealistic.

Respectfully,

Walter T. Gangl

Walter T. Gangl, Chair

encls.

cc: David Smith, President - ASCS
Michael Goodman, Vice President - ASCS

Mission Statement
of
The Nonprofit Committee
of
The American Society of Corporate Secretaries

The Mission of the Nonprofit Committee is to enhance the significant role of nonprofit organizations in our society by providing educational resources to promote effective governance structures, and to stimulate commitment to corporate volunteerism in nonprofit governance by members of the Society.

To carry out its Mission, the Committee will:

- Promote the volunteer ethic within the Society by emphasizing the needs of nonprofit organizations with respect to governance, and facilitating the sharing of resources and mentoring expertise
- Increase representation of nonprofit membership in the Society
- Utilize existent relationships that members of the Society have with nonprofits and encourage development of networking opportunities
- Solicit additional Committee members from a broad geographical spectrum who represent both for profit and nonprofit members of the Society
- Heighten the Chapters' awareness of the Committee's Mission in an effort to develop regional outreach efforts and solicit feedback
- Provide opportunities for collaboration and resource sharing with other national organizations dedicated to preserving the strength of the nonprofit sector.
- Publish or collaborate in the production of materials to assist in the education of nonprofits regarding the broad spectrum of issues necessary for solid corporate governance
- Spearhead the process of enabling the Society to become a valuable resource for federal and state documents to help ensure nonprofit regulatory compliance
- Initiate implementation of a reference source for nonprofits through creation of a web site or "mentoring" list of Society members available for consultation
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- Continuously brainstorm to create new opportunities of adding value to nonprofit organizations and the philanthropic endeavors of the for profit sector.

American Society of Corporate Secretaries
Nonprofit Committee
Walter T. Gangl, Chair
P.O. Box 3001; Bldg. 701
Lancaster, PA 17604

May 28, 1999

Securities and Exchange Commission
Attn: Jonathan Gottlieb, Esq.
Washington, DC 20549
Fax # : 202-942-9624

Re: Rep. Gillmor's revised Charitable Contributions Disclosure Proposal

Dear Mr. Gottlieb:

We are gratified to note that many of our comments previously submitted concerning the prior version of this bill were reflected in the revised proposal. As revised, the bill is a substantial improvement and we commend the drafters for the changes. For the reasons explained in our previous comment letter, however, we remain concerned about the second section of the bill.

The first section of the bill addresses a worthy disclosure issue. We recognize that there is a legitimate concern about the potential for charitable contributions by a company to compromise the independence of the company's directors who have major roles with the recipient charity. Experience has shown that, although rare, such incidents do occur, and do have a real potential to affect the independent judgment of directors. With the proposed provision for an appropriate dollar threshold to avoid the cost and burden of meaningless disclosure, the proposed bill would require disclosure of significant charitable contributions to nonprofits with major connections to a director of the donor company. This would fit naturally and logically in the typical "Related Party Transactions" section of most proxy statements.

The second section of the revised bill, however, still presents significant problems. This would require annual statements by public companies of the total amount of their charitable contributions and the identity of nonprofits that receive amounts in excess of a threshold to be set by the SEC. It would be left to the SEC to prescribe where and in what format this disclosure is "made available." The bill also does not specify to whom the information must be made available: the public or only shareholders? This is an important issue.

As explained in our previous comments, it is not clear what problem this proposal is attempting to address. Experience has conclusively shown that <u>there is little to no shareholder interest in this subject</u>. When given the opportunity to vote on such disclosure, shareholders have consistently voted <u>against</u> it by wide margins. Several companies voluntarily make such information available to the public or shareholders, but their reports generally receive scant attention. So it is doubtful any benefit would come from this proposal.

On the other hand, requiring public companies to disclose the amount and certain recipients of their charitable contributions could lead to the harmful consequences cited in our prior comment letter. Companies would feel pressured to favor "safe" non-controversial charities and those with "name recognition" that would garner public support, over smaller, local charities and those consistent with the company's interests. Companies would then be subject to annual surveys of giving, and be compared, dissected and, in some cases, criticized for their magnanimous, penurious, or politically incorrect giving depending on the political views of the reader.

Of course, companies will always be obliged to account to the Internal Revenue Service for their actual contributions. Many companies also voluntarily elect to garner good will and recognition through their contributions and other community involvement. The issue posed by the second section of this bill is whether mandatory disclosure, and the attendant publicity, comparisons, and criticism of companies from some circles that would surely result, and the changes in giving patterns affecting small and less popular nonprofits that will also result, are necessary to serve some greater public interest. Of course, as noted above, there is no such countervailing public interest, and we respectfully urge that the second section of this revised bill be dropped from the proposal.

If, however the second section of the bill should be enacted, then high disclosure thresholds, with inflation adjustments incorporated, will be needed to minimize the adverse consequences on nonprofits and donor corporations. There is no significant value in disclosure of *de minimus* contributions. Accordingly, no disclosure should be required if the aggregate amount of a corporation's charitable contributions does not exceed 2.5% of consolidated revenues, and contributions to individual charities should not be disclosed unless they exceed $250,000.

Attached, for reference are out prior comment letters on this matter. We appreciate the opportunity to voice our opinions on this subject.

Yours truly,

Walter T. Gangl

Walter T. Gangl, Chair

cc: Hon. Paul E. Gillmor
1203 Longworth House Office Building
Washington, DC 20515

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