

2. Compounding

The proposed Estimated Yield Formula would omit a step proposed by the ICI in which a trust's average yield to maturity is divided by twelve and re-annualized using a method that, in effect, would compound a monthly yield. The Commission is concerned that such a calculation could materially overstate the anticipated yield of a trust and is not proposing to provide for compounding of a trust's average yield to maturity.

In its request for rulemaking and in other correspondence with the staff, the ICI has argued that Fixed Income UITs primarily compete with mutual funds.²⁷ Mutual funds calculate yield according to a Commission formula that effectively compounds earnings.²⁸ The ICI believes that Fixed Income UITs also should be permitted to compound earnings or they would be placed at a competitive disadvantage to mutual funds.²⁹

The compounding element of the mutual fund yield formula reflects the internal compounding of dividends within mutual funds as a result of their reinvestment of interest from bonds (and other securities) upon receipt. Because of the fixed nature of UITs, interest payments received are not reinvested, but are held by the trust's custodian until they are distributed to unitholders, and thus no compounding occurs within the UIT.³⁰ The ICI has suggested, however, that because dividends distributed to unitholders may be reinvested in a mutual fund made available by a UIT sponsor, unitholders may obtain the benefits of compounding. A similar argument may be made for compounding the calculation of yield to maturity of a bond. In both the cases, however, such a yield would not constitute a yield from an investment, but from an

investment plan. Moreover, the ICI's proposed formula would assume reinvestment of interest payments immediately upon receipt by the trust and would not reflect the delay from the time a trust receives the coupon payments until it distributes those payments to unitholders, when only then could they reinvest the distributions.³¹

In developing this proposal and reviewing the ICI proposal, the Commission has been primarily concerned with the accuracy of the formula. Compounding yield to maturity of a trust's portfolio securities would result in a trust advertising an Estimated Yield of the UIT that is *higher* than the yield an investor would have obtained if the investor purchased each security outside of the UIT. For example, if a bond trading at par with a yield to maturity of 8 percent is deposited into a UIT (assuming no trust expenses or sales load), the ICI-proposed formula would produce a yield of 8.13 percent.³² To avoid such a result, the Commission is not proposing that the Estimated Yield Formula provide for compounding.

Comment is requested whether the Estimated Yield Formula should contain an element of compounding. Commenters supporting compounding should address the variance that would be created between the yields to maturity of the bonds in which UITs invest and Estimated Yield that would be calculated under such a formula.

3. Accrued Interest

The public offering price of units of a Fixed Income UIT includes not only the price of the securities in a portfolio plus a sales charge, but also a proportionate share of accrued interest of each security in the trust.³³ The amount an investor pays for the purchase of a bond, also includes accrued interest. The calculation of a bond's yield to maturity excludes consideration of the accrued interest because it will be returned to bondholders upon receipt of the next interest payment. Thus, the amount of accrued interest paid by a purchaser of a bond does not represent part of the bondholder's investment. In contrast, all of the accrued interest paid by a

unitholder of a UIT will not be returned in the trust's first distribution; some or all will remain part of the net asset value of the trust and will be used to eliminate fluctuations in periodic distributions and to compensate the trustee who has use of the cash.

Unitholders generally receive equal distributions, on a monthly, quarterly, semi-annual, or annual basis, based on the interest income of the bonds in the portfolio less expenses. Because interest on the bonds is not received at a constant rate throughout the year, a trust may not have cash from interest payments available to meet distributions to unitholders at the end of a period. In such a case, the trustee will draw on the accrued interest account, which will be replenished during a period in which interest is received in excess of what is needed to make distributions to unitholders. A trust's retained accrued interest balance generally remains positive after the trust's first distribution.³⁴ Each unit's proportionate share of retained accrued interest, if any, is part of the trust's net asset value. As such, it is returned to unitholders upon redemption, sale of a unit, or liquidation of the trust.³⁵

The proposed Estimated Yield Formula would reflect the delay in repayment of accrued interest by treating accrued interest as of the date of deposit as a trust asset.³⁶ The formula would achieve this result by requiring Fixed Income UITs, in calculating the yield to maturity of each bond in the trust's portfolio, to subtract from the amount of the bond's first coupon payment and to add to the amount of the bond's last coupon payment the amount of the bond's accrued interest as of the date of deposit of the bond in the trust.³⁷ The Commission requests comment on the proposed treatment of accrued interest under the Estimated Yield Formula.

³⁴ See letter from David Silver, President, Investment Company Institute, *supra* note 10.

³⁵ In addition, as securities in the portfolio mature, or are called or sold, the accrued interest applicable to such bonds is distributed to unitholders.

³⁶ In its 1989 submission, the ICI proposed to treat accrued interest as a non-earning asset, although the method used would have been different from that of the proposed Estimated Yield Formula, reflecting differences in the two formulas. See letter from David Silver, President, Investment Company Institute, *supra* note 10. The ICI's 1995 submission, upon which the Estimated Yield Formula is based, does not appear to provide for similar treatment.

³⁷ Instruction 2 to the proposed Estimated Yield Formula. This Instruction would not apply to trusts in which all accrued interest at the date of deposit is paid by the sponsor or a person other than a unitholder.

²⁷ See letter from Craig S. Tyle, Vice President and Senior Counsel, Investment Company Institute, *supra* note 12; letter from David Silver, President, Investment Company Institute, *supra* note 10; letter from Craig S. Tyle, Associate General Counsel, Investment Company Institute, to Gene Gohlke, Acting Director, Division of Investment Management (June 29, 1990). A copy of each letter is contained in File No. S7-32-95.

²⁸ Item 22(b) of Form N-1A under the 1940 Act [17 CFR 274.11A].

²⁹ In an earlier submission, however, the UIT industry asserted that the formula should replicate the yield of a bond. See letter from James J. Wesolowski, Vice President and General Counsel, John Nuveen & Co. Inc., *supra* note 10. This submission included a proposed formula, the ELTR formula UITs currently use to calculate yield, that does not compound yield to maturity.

³⁰ To the extent that the use of the dividends and other income by the trust custodian before their distribution reduces the custodian's fees and thus UIT expenses, their use already would be reflected in the proposed Estimated Yield Formula as a higher resulting Estimated Yield.

³¹ See letters from the Investment Company Institute cited in *supra* note 27.

³² Higher yields would produce greater differences between the yields.

³³ Accrued interest on the purchase of a bond is the dollar amount of interest, based on the coupon rate of interest, which has accumulated on a security from the most recent interest payment date up to but not including the date of settlement of the purchase. Accrued interest is paid to the seller by the purchaser of a bond.