The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC STAFF ISSUES 1995 GENERIC COMMENT LETTER AND SUPPLEMENTAL GENERIC COMMENT LETTER TO INVESTMENT COMPANY CFOS

February 7, 1995 TO: ACCOUNTING/TREASURERS MEMBERS No. 9-95 CLOSED-END FUND MEMBERS No. 4-95 COMPLIANCE COMMITTEE No. 7-95 INDEPENDENT ACCOUNTANTS ADV. GROUP No. 2-95 SEC RULES MEMBERS No. 8-95 UNIT INVESTMENT TRUST MEMBERS No. 8-95 RE: SEC STAFF ISSUES 1995 GENERIC COMMENT LETTER AND SUPPLEMENTAL GENERIC COMMENT LETTER TO INVESTMENT COMPANY CFOs

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The Division of Investment Management has issued its "generic comment letter" for 1995, providing assistance to investment company registrants in preparing disclosure documents to be filed with the Commission. In addition, the staff issued a supplement to its "generic comment letter" to investment company chief financial officers, dated November 1, 1994. Copies of these letters (which are summarized below), as well as the November 1 letter to CFOs, are attached. Disclosure and Procedural "Generic Comment Letter" I. Filing Procedures A. Post-Effective Amendments Under Rules 485 and 486 The letter briefly describes the recent amendments to Rule 485 under the Securities Act, which governs the procedures by which mutual funds file post-effective amendments to registration statements. These amendments became effective on October 11, 1994. The letter states that with respect to the new provision of Rule 485 allowing the staff to permit certain post-effective amendments not otherwise eligible to be filed under Rule 485(b) to become effective immediately upon filing, the staff has permitted the automatic effectiveness of a post-effective amendment filed by one fund in a complex when the amendment reflects substantially identical revisions to those contained in a post-effective amendment of another fund in the complex previously reviewed. In addition, the letter states that requests pursuant to this provision should be addressed in writing to the Assistant Director, Office of Disclosure and Review. The letter also notes that the Commission has adopted Rule 486 under the Securities Act, to permit interval funds (i.e., closed-end funds that repurchase their shares periodically in accordance with Rule 23c-3) to file certain post-effective amendments and registration statements that become effective immediately. B. Amendments to Proxy Rules The letter briefly describes the recent amendments to the proxy rules applicable to investment companies, which were effective on November 23, 1994 and apply to all proxy statements filed on or after January 23, 1995. In addition, the letter clarifies an issue that arose under the amendments concerning the appropriate disclosure in a proxy statement of compensation of directors serving on more than one board of funds in a fund complex with different fiscal years. The letter also reminds

registrants that the compensation table required to be included in the registration statement, as well as in the proxy statement, should be included in the first post-effective amendment filed on or after January 23, 1995 and may be filed under Rule 485(b) if it is otherwise eligible for such a filing. New registration statements should include the table with amounts estimated for the first fiscal year, but using actual fund complex information if it is available. C. Registration of Additional Shares Pursuant to Rule 24e-2 Registrants are reminded that under Rule 24e-2 (which permits mutual funds and unit investment trusts that are registering additional shares to "net" redemptios or repurchases in calculating the filing fee), net redemption credits may be preserved only if a post-effective amendment containing the information required by Rule 24e-2(b) is filed in the year immediately following the fiscal year in which the net redemptions occur. D. EDGAR Implementation The letter discusses the phase-in schedule for investment companies that are not already filing on EDGAR; describes the paper filing requirement for registrants making their first EDGAR filing; reminds registrants that all correspondence related to electronic filings must also be submitted electronically; clarifies the Financial Data Schedule filing requirement for EDGAR filers; and identifies SEC staff personnel who should be contacted with any questions regarding the EDGAR phase-in or the EDGAR rules. E. Filings Under Rule 497 Registrants are reminded that they may not materially alter the nature of the fund contemplated in the last pre-effective amendment by merely filing a Rule 497(b) or (c) prospectus that makes those material changes. Instead, a post-effective amendment must be filed under Rule 485(a). II. Disclosure Comments A. Disclosure Regarding Management’s Discussion of Fund Performance The letter reminds registrants who include their Management’s Discussion of Fund Performance in their annual reports that Item 32(c) of Form N-1A requires an undertaking to furnish a copy of the fund’s latest annual report, upon request and without charge, to every person to whom a prospectus is delivered. In addition, Item 3 of Form N-1A requires disclosure in the prospectus that further information about the registrant’s performance is contained in the annual report, which may be obtained without charge. B. Fund Names and Guide 1 The letter states that where a fund names suggests that all, or substantially all, of the fund’s assets will be invested in a certain type of security, industry, country or geographic region, the fund’s investment policy should conform with the higher threshold implied by its name, rather than the 65% threshold required in Guide 1 to Form N-1A for a fund whose name suggests it will invest primarily in a particular type of security, industry or industries. C. Updated Risk Disclosure Registrants are reminded that they have an ongoing duty to analyze fund risk and review prospectus risk disclosure, and to update that disclosure when appropriate. The letter makes clear that registrants cannot rely on the Commission to identify changes in the significance of certain risk factors that may occur or new risk factors that may be introduced as a result of changes in the marketplace. III. Recent Staff Positions A. No-Action Letters The letter summarizes several no-action letters issued during the past year dealing with the following issues: (1) shareholder approval of a fund’s advisory contracts following the acquisition of the fund’s adviser shortly after commencement of the fund’s public offering of its shares; (2) advertising past performance following a reorganization; (3) treatment of privately issued asset-backed and mortgage-backed securities for diversification purposes; and (4) eligibility of certain notes for purchase by money market funds under Rule 2a-7. B. Rule 12b-1 Carry-Forwards The letter states that the staff will not raise objections under Section 17(d) of the Investment Company Act or the rules thereunder if a Rule 12b-1 plan allows for the transfer of a portion of a mutual fund’s "remaining account" (i.e., the appropriate maximum aggregate sales charge minus the amount of sales charges paid or accrued, including asset-based sales charges, front-end and deferred sales charges, plus the permitted interest) in the event of an exchange between series of the same mutual fund or between affiliated mutual funds. The staff’s position is conditioned upon the following: (1) the arrangement is conducted in

accordance with Section 26(d)(2)(D) of the NASD's Rules of Fair Practice, as described more fully in NASD Notice to Members 93-12 (February 1993), and (2) the carry-forward arrangement is implemented in accordance with Rule 12b-1. C. Money Market Funds The letter discusses the interpretative guidance recently provided by the Commission and the staff concerning certain floating rate and other securities that are inappropriate for money market funds. The letter also reiterates that an adviser must determine not only that holding the security is not expressly prohibited by Rule 2a-7, but also that the security meets 1 For purposes of the positions taken in the letter, enhanced securities include separate and distinct credit mechanisms provided to maintain the carrying value of an investment. Although not specifically addressed by the letter, "portfolio insurance," not tied to an individual security but guaranteeing the timely payment of interest and principal for investments in the portfolio is also considered a form of enhancement requiring the disclosure, valuation and capital recognition discussed therein. the general rule applicable to all investments by a money market fund: that investment in the security is consistent with maintaining a stable net asset value per share. D. Bundling of Proxy Proposals In response to issues that have been raised about whether proposals for shareholder approvals may be "bundled", i.e., submitted and voted upon together in fund proxies, the letter states that a matter should be voted upon separately if the Investment Company Act, state law or a fund's organizational documents require a matter under consideration to be submitted to shareholders. The letter goes on to state that the staff has not objected to "bundling" proxy proposals in the following circumstances: (1) proposals involving editorial or non-substantive changes to fund documents, (2) where the proposals would be impractical to separate and (3) approval of new advisory contracts, Rule 12b-1 plans and other matters necessary to implement a fund merger. E. Prospectus Simplification The staff continues to encourage registrants to take the initiative to review, simplify and improve fund prospectuses. Supplemental "Generic Comment Letter" for CFOs A. Applying SFAS #119 to Investment Companies SFAS #119, issued by the Financial Accounting Standards Board in October 1994, requires financial statement disclosures about certain derivative financial instruments. Paragraph 9 of SFAS #119 makes a distinction between financial instruments held or issued for trading purposes and financial instruments held or issued for purposes other than trading. The letter states that investment companies should designate each derivative covered by SFAS #119 as either held or issued for trading purposes or held or issued for purposes other than trading, and should make the designation at the time the derivative financial instrument is acquired. The letter goes on to state that funds have a continuing obligation to regularly evaluate the appropriateness of the original designations, which could lead to changes in a designation, and, accordingly, differences in disclosure requirements during the holding period of the instrument. B. Presentation and Accounting for Enhanced Securities1 1. Valuation - The letter states that credit enhancements provided to maintain the carrying value of an investment have been segregated into the two commonly used types, typically issued through the adviser: non-transferable put options and non-transferable letters of credit. The staff believes that for these enhancements, valuing each component separately is appropriate. 2. Presentation - The letter expresses the staff's view that separate and distinct disclosure of the components of a credit-enhanced security should be provided, and is required in certain instances by Items 6-04.1 and 6-04.3 of Regulation S-X. The letter provides guidance as to the appropriate disclosure that should be provided for put options and letters of credit. In addition, the letter notes that the disclosure should also comply with requirements of Statement of Financial Accounting Standards number 57 - Related Party Disclosures ("SFAS 57") issued by the Financial Accounting Standards Board. 3. Transferable Enhancements - According to the letter, separate valuation and presentation of the components of investments with transferable enhancements would not be required. The presentation of securities with

transferable enhancements on the portfolio of investments schedule should identify the name and relationship of the issuer of the enhancement. The terms, conditions and other arrangements related to the enhancement should be disclosed in the notes to the financial statements. 4. Contribution to Capital - Consistent with prior guidance, the letter indicates that a contribution to capital is made at the time the enhancement (whether transferrable or non- transferrable) becomes available to the fund. The amount of the contribution is measured by the cost of obtaining a similar enhancement in an arm's-length transaction. The letter further states that any change in the value of the enhancement would be recorded as unrealized appreciation or depreciation. There would be no adjustment to contributed capital as a result of a change in value of the enhancement or the disposition of that enhancement. * * * Amy B.R. Lancellotta Associate Counsel Gregory M. Smith Director - Operations/ Compliance & Fund Accounting Attachments

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