

MEMO# 1737

February 27, 1990

STAFF ISSUES ADDITIONAL LETTER ON DISCLOSURE REQUIREMENTS FOR FUNDS THAT INVEST IN HIGH YIELD BONDS

February 27, 1990 TO: SEC RULES MEMBERS NO. 16-90 CLOSED-END FUND MEMBERS NO. 10-90 UNIT INVESTMENT TRUST MEMBERS NO. 12-90 HIGH YIELD BOND TASK FORCE RE: STAFF ISSUES ADDITIONAL LETTER ON DISCLOSURE REQUIREMENTS FOR FUNDS THAT INVEST IN HIGH YIELD BONDS

The staff of the Division of Investment Management has sent the attached letter to the Institute clarifying the nature of the disclosure it is requesting of registrants that invest in high yield bonds. Last October the staff sent a letter to all investment company registrants, setting forth its views on appropriate disclosure in this area. (See Memorandum to SEC Rules Members No. 55-89, Closed-End Fund Members No. 49-89 and Unit Investment Trust Members No. 52-89, dated October 5, 1989). The Institute subsequently formed a Task Force to review the staff's letter. The Institute and the Task Force sought clarification on many items mentioned in the October letter through a series of meetings and correspondence. In the attached letter, the requested disclosure has been modified or clarified in several instances. In addition, the staff has requested additional disclosure in certain cases. Set forth below is a summary of some of the more significant items in the letter.

Application to Investment Grade Debt. As suggested by the Institute, the staff states that the specific disclosure items discussed in the October letter are generally not appropriate for investment grade bonds, including those bonds rated in the lowest category of investment grade (e.g., those rated "BBB" by Standard & Poor's or "Baa" by Moody's). Instead, registrants that invest in those bonds, but not in lower-rated bonds, should disclose that such bonds may have speculative characteristics and that changes in economic conditions or other circumstances are more likely to lead to a weakened capacity to make principal and interest payments than is the case for higher grade bonds.

-2- Municipal Bond Funds. In its letter, the staff states that it believes that lower-rated municipal bonds involve most of the risk factors set forth in the October letter. However, it is willing to consider a registrant's arguments, "supported by facts or analysis", that certain of those risk factors are not applicable.

Location of Disclosure. The staff endorsed the Institute's suggested guidelines for when risk disclosure should appear in the prospectus or SAI. Funds that invest, or anticipate investing, no more than five percent of assets in high yield bonds may identify that fact in the prospectus and include appropriate risk disclosure in the SAI. Funds that invest up to 35 percent of assets in high yield bonds may, in many cases, include a concise summary of pertinent risk factors in the prospectus, with a more complete description in the SAI. Funds that invest over 35 percent of assets in high yield bonds

should include full risk disclosure in the prospectus. In any case, if a fund materially deviates from its intent, it should make appropriate modifications to its disclosure.

Identification of Bonds as "Junk". The staff is requesting that funds that invest in high yield bonds (1) prominently note in their prospectuses that high yield bonds are commonly known as "junk bonds", (2) use the term "junk bond" in the fund's name or (3) when using the term "high yield", immediately precede or follow it with "high risk". (The staff had suggested identifying high yield bonds as junk bonds at a meeting with the Institute on October 31. The Institute opposed the suggestion).

Legend. The staff is "strongly encourag[ing]" funds that invest 35 percent or more of assets in high yield bonds to include a legend on the cover page of the prospectus highlighting the risks of such investments.

Description of Ratings. Funds that invest over 5 percent of assets in high yield bonds should include an appendix describing the ratings assigned to portfolio securities. In the case of funds that invest under 35 percent of assets in high yield securities, the appendix may be included in the SAI, provided that the prospectus contains a concise summary of the characteristics of the ratings, especially the lowest rating in which the fund may invest.

Specific Disclosure Items. The staff's letter modifies, in many respects, the requested disclosure set forth in the October letter. In certain cases, the staff has suggested additional disclosure (e.g., that yields will fluctuate over time, that achievement of a fund's investment objective may be more dependent on its own credit analysis than is the case for higher rated bonds). In other instances the staff has stated that -3- disclosure items are only appropriate in some cases (e.g., recovery expenses on defaulted bonds, risks of reliance -4- on ratings) or generally not required (e.g., effects of calls in a declining rate environment, the need for some shareholders to redeem shares to pay taxes). The staff has also clarified its requested disclosure under "Liquidity and Valuation" to remove any suggestion that a fund's board will be unable to fulfill its obligation to value high yield bonds.

Asset Composition Disclosure. Although the Institute opposed the staff's suggested asset composition disclosure (see Memorandum to SEC Rules Members No. 6-90, Closed-End Fund Members No. 4-90 and Unit Investment Trust Members No. 6-90, dated January 26, 1990), the staff is requesting that this disclosure be included in the prospectus of any fund that invests at least 5 percent of its assets in high yield bonds. The calculation should be made on a dollar weighted basis, computed at least monthly. Craig S. Tyle Associate General Counsel Attachment