

**MEMO# 1453**

October 5, 1989

# **INVESTMENT MANAGEMENT LETTER ON PROSPECTUS DISCLOSURE ON HIGH YIELD BONDS**

October 5, 1989 TO: SEC RULES MEMBERS NO. 55-89 CLOSED-END FUND MEMBERS NO. 49-89 UNIT INVESTMENT TRUST MEMBERS NO. 52-89 RE: INVESTMENT MANAGEMENT LETTER ON PROSPECTUS DISCLOSURE ON HIGH YIELD BONDS

The Division of Investment Management has distributed a letter to investment company registrants that sets forth its views on the nature of prospectus disclosure required of investment companies that invest in high yield bonds. The requested disclosure includes discussion of specific risk factors, as well as a tabular or narrative presentation of the percentages of total assets represented by bonds in different rating categories, and by unrated bonds. The letter, a copy of which is attached, requests all registrants to take "immediate steps" to review current disclosure and, to the extent necessary, amend such disclosure. The letter states that any such amendments may be effected by the stickering process under Rule 497 under the Securities Act. The letter also states that the General Instructions to Form N-1A and Guide 3 thereto should be consulted in order to determine whether the required disclosure should be included in the prospectus or the Statement of Additional Information. The letter states that registration statements of investment companies that invest in bonds rated other than high-grade should "highlight" the risk factors associated with such investments that were discussed in the recent SEC Release on disclosures about securities issued in leveraged transactions. (Relevant excerpts from that Release were previously sent to you. See Memorandum to SEC Rules Members No. 27-89, Closed-End Fund Members No. 23-89 and Unit Investment Trust Members No. 28-89, dated May 22, 1989.) The staff letter also recommends that certain specified risk factors associated with high yield bonds be disclosed in the registration statement. These include: (1) Youth of Market. The letter states that many high yield securities have been issued after the last recession. Accordingly, the impact of an economic downturn on the market and on the value of such securities should be disclosed. (2) Sensitivity to Interest Rates and Economic Changes. The letter notes that high yield bonds are generally less sensitive to interest rate changes but states that they may be more sensitive to adverse economic changes or individual corporate developments. It notes that zero coupon and payment-in-kind bonds also may have a higher degree of interest rate sensitivity. (3) Payment Expectations. The letter states that bonds with call provisions may present risks due to the exercise of such provisions in a declining interest rate environment. (4) Liquidity and Valuation. Investment companies are requested to disclose, to the extent there is no established secondary market, the impact of this on their ability to accurately value securities and to dispose of them. (Specific investment policies to reduce "liquidity risk" should also be disclosed.) Disclosure of the effects of adverse

publicity and investor perceptions is also requested. The letter states that any material change in a registrant's portfolio liquidity would require stickering. (5) Congressional Proposals. Investment companies are requested to disclose the possible impact of new laws and proposed new laws on the high yield market (e.g., the savings and loan bill, tax proposals). (6) Taxation. Investment companies are requested to disclose special tax considerations involved in investing in high yield bonds such as zero coupon and payment-in-kind securities. (7) Credit Ratings. Investment companies are requested to disclose the nature of the lowest rating of securities in which they invest. In addition, disclosure should be made concerning the risks of using ratings to evaluate bonds (e.g., the failure of rating agencies to reflect changes on a timely basis). The letter states that funds should be "continuously monitoring" high yield bond issuers in view of the limitations of rating agencies. Unit investment trusts should disclose any added risks of having a portfolio that is not actively managed. In addition to the risk factors and special considerations set forth above, prospectuses should contain disclosure of the percentages of total assets represented by (1) rated securities, separated by rating category; (2) unrated bonds as a group, and (3) unrated bonds determined by the fund's board to be comparable in quality to rated bonds, separated by rating category. Any "material deviations" in future years should be "explained in future filings." We will keep you informed of further developments in this area. Craig S. Tyle Assistant General Counsel Attachments