

MEMO# 6410

November 23, 1994

APPEALS COURT REVERSES DECISION ON HIGH-YIELD BOND FUND DISCLOSURE

November 23, 1994 TO: CLOSED-END FUND COMMITTEE No. 29-94 SEC RULES COMMITTEE No. 125-94 RE: APPEALS COURT REVERSES DECISION ON HIGH-YIELD BOND FUND DISCLOSURE

As we previously informed you, last year the United States District Court for the District of Massachusetts held that the prospectuses of two high yield bond funds were not misleading and granted defendants' motion for summary judgment. (See Memorandum to Closed-End Fund Committee No. 26-93, SEC Rules Committee No. 101-93, dated November 5, 1993.) The United States Court of Appeals for the First Circuit recently reversed the district court's decision. A copy of the appeals court's decision is attached. The plaintiff investors had sued the funds, several of their officers and directors, and their underwriters, alleging violations of Sections 11 and 12(2) of the Securities Act of 1933. The plaintiffs asserted that the funds' prospectuses were misleading because they stated that from 1977 through 1986, on average, junk bonds yielded 3.93% more annually than U.S. Treasury bonds, but did not disclose that the return on a diversified junk bond portfolio was less than the return on Treasury bonds from 1982 through 1987. The plaintiffs also alleged that the prospectuses failed to disclose that default rates rise as bonds age and quoted a default loss rate that did not account for "forced bond exchanges." The appeals court held that it "cannot say as a matter of law that the undisclosed information about the six-year period would not alter the total mix of facts available to the investor. Rather, a jury could find that there is a substantial likelihood that a reasonable shareholder would consider the six-year comparison important to the investment decision." The court reversed and remanded the case to permit further discovery, especially concerning the defendants' knowledge about the six-year return. The appeals court found no error in the district court's grant of defendants' motion for summary judgment on the issues concerning bond aging and forced bond exchanges. Thomas M. Selman Associate Counsel Attachment