MEMO# 2335

November 16, 1990

STATE COMPLAINTS ALLEGING MISLEADING PROSPECTUS DISCLOSURE BY HIGH YIELD BOND FUNDS

-1- November 16, 1990 TO: SEC RULES COMMITTEE NO. 61-90 HIGH YIELD BOND TASK FORCE RE: STATE COMPLAINTS ALLEGING MISLEADING PROSPECTUS DISCLOSURE BY HIGH YIELD BOND FUNDS ____ As you may know, the New York State Attorney General and the Massachusetts Secretary of State recently have filed suit against a mutual fund sponsor alleging fraudulent sales practices in connection with the sale of two high yield bond funds. While most of the allegations contained in the complaints concern sales practices, both states also allege that the funds' prospectuses were misleading and materially omissive. In particular, both states alleged that the following prospectus statements were misleading (emphasis in complaints): a) "[T]he emphasis is on those securities offering the highest current or potential yield provided it is determined that excessive risk is not involved ." b) "These securities [junk bonds] offer, in the Investment Advisor's judgement, the highest available current yield with a level of risk acceptable to the Investment Advisor." c) "[T]he Fund will not invest in securities rated B or lower by Moody's or Standard & Poor's, or unrated securities, unless the Investment Advisor believes the financial condition of the issuer or other available protections reduce the risk to the Fund." d) "these risks [of purchasing `restricted', i.e. unmarketable securities, and of fluctuating interest rates] cannot be eliminated, but may be significantly reduced by diversifying holdings to minimize the portfolio impact of any single investment." e) "In unusual market and economic conditions the -2- Fund, for temporary defensive purposes, may invest -3- up to 100% of its assets in investment grade debt securities, preferred stocks, government securities or hold its assets in cash." Further, the New York complaint alleged that the prospectuses "throughout the 1980's" failed to disclose certain risk factors, many of which were the subject of SEC staff letters on high yield bond fund disclosure issued in 1989 and 1990. The complaint states that the following risk factors were not disclosed prior to December 29, 1989: a) that the funds invest in the unsecured debt obligations of highly leveraged, non-investment grade issuers, commonly known as junk bonds; b) that the ability of junk bond issuers to timely pay principal and interest is predominantly speculative; c) that the high current yield of junk bond funds is an inducement to accept the risk of a loss of principal when portfolio bonds default or decline in value due to deteriorating payment prospects; d) that the funds invest in bonds where the issuer's earnings are less than required debt service; and e) that the funds' junk bond assets cannot be sold as easily as high quality bonds causing valuation difficulties and a greater risk of loss of principal than the risk inherent in the purchase of investment grade bonds; The complaint also states that the funds' current prospectuses are "materially omissive" in that they failed to disclose the following: a) that the ability of junk bond issuers to timely pay principal and interest is predominantly speculative; b) that the funds invest in bonds where the issuer's earnings are less than required debt service; c) that the high current yield of junk bond funds is an inducement to accept the risk of loss of principal when portfolio bonds default or decline in value due to deteriorating payment prospects; d) that it is uncertain whether the higher yield of junk bond investments is adequate to compensate for the default and market risks of owning these securities; and -4- e) that the funds' total return (income adjusted by principal loss or gain) has been negative and, indeed, lower than other junk bond funds or junk bond market indices. We will keep you informed of developments. Craig S. Tyle Associate General Counsel

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