

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

October 3, 1989

Dear Investment Company Registrant:

The Division of Investment Management has reviewed disclosure practices of investment companies that invest, or are permitted to invest, all or a significant portion of their assets in high yield or "junk" bonds in light of recent disclosure developments and recent activity in the junk bond market. 1/ Our objective is to ensure that the risks associated with these investments are presented fully and fairly in an investment company's registration statement. 2/

As discussed in more detail below, the registration statement should highlight: (1) the risk factors noted in a recent Commission release; (2) additional risk factors related to (a) the relative youth and accelerated growth of the high yield bond market in an era of economic expansion, (b) the sensitivity of high yield securities to interest rate and economic changes, (c) the degree of protection of principal and interest payments, (d) the relatively low trading market liquidity for these securities and its effect on valuation, (e) the impact that legislation may have on the high yield bond market and an investment company's net asset value and investment practices, (f) special tax consequences, and (g) the high yield securities' credit rating and the creditworthiness of the issuers; and (3) a statistical breakdown of the investment company's assets in high yield securities.

The purpose of this letter is to request that you take immediate steps to review your disclosure. To the extent that your current prospectus and statement of additional information do not identify and discuss the special considerations and risk factors discussed here, they should be amended to do so. The disclosure changes may be effected through the use of the

---

1/ These bonds would include those other than high-grade (e.g., bonds receiving a Standard & Poor's rating of BBB or lower or a Moody's rating of Baa or lower). See Guide 20 of Form N-1A.

2/ See General Instruction G and Guide 3 in Form N-1A for guidance on whether, and to what extent, disclosure should be made in the prospectus and/or the statement of additional information.

"sticker" process under Rule 497 under the Securities Act of 1933. This letter also serves as a guide to the issues the Division staff will raise as comments in its review of new registration statements.

Special Considerations - Risk Factors

A. Release IC-16961

Recently, the Commission issued a release discussing its position regarding disclosure about investments in securities issued in highly leveraged transactions. 3/ The release identified a number of items which corporations, including investment companies, should consider including in their registration statements to assure adequate disclosure: (1) relevant lending and investing policies, including credit and risk management policies; (2) the amount of holdings, stated separately by type if individually material, including guarantees and repurchase or other commitments to lend or acquire such loans and investments, and the potential risks inherent in such holdings; (3) information regarding the level of activity during the period, e.g., originations and retentions; (4) amounts of holdings, if any, giving rise to significantly greater risks (that may have material effects on financial condition or results of operations) than are present in other similar transactions and instruments; for example, where the issuer is bankrupt or has issued securities on which interest payments are in default, or where there are significant concentrations (e.g., in an individual borrower, industry or geographic area), particularly where those concentrations are in securities with relatively low trading market liquidity (such as those that depend upon a single market maker for their liquidity); and (5) analysis of the actual and reasonably likely material effects of the above matters on income and operations, e.g. the amounts of fees recognized and deferred, yields, amounts of realized and unrealized market gains or losses, and credit losses.

In addition, the Commission identified risks specifically applicable to investment companies investing in high yield securities which should be disclosed. These risks include, but are not limited to, market price volatility based upon interest rate sensitivity, creditworthiness, relative liquidity of the secondary trading market, and the effects such risks may have on the net asset value of the investment company. Also, the board

---

3/ Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Release Nos. 33-6835, 34-26831, IC-16961, FR-36 (May 18, 1989).

of directors of an investment company that invests in such securities should carefully consider factors affecting the secondary market for such securities in determining whether or not any particular security is liquid or illiquid, and whether market quotations are "readily available" for purposes of valuing portfolio securities.

B. Staff Guide

The Division staff recommends that the following additional risk factors associated with investment company investments in high yield bonds be discussed in the registration statement.

Youth and Growth of High Yield Bond Market. Since the high yield bond market is relatively new, its growth has paralleled a long economic expansion, and it has not weathered a recession in its present size and form, investment companies should disclose the effects an economic downturn or increase in interest rates is likely to have on the high yield bond market and on the value of high yield bonds in their portfolios. For example, a GAO study states that the widespread expansion of government, consumer and corporate debt within our economy has made the corporate sector, especially cyclically sensitive industries, more vulnerable to economic downturns or increased interest rates. It further states that an economic downturn could severely disrupt the market for high yield bonds and adversely affect the value of outstanding bonds and the ability of the issuers to repay principal and interest. 4/

Sensitivity to Interest Rate and Economic Changes. Investment companies should disclose how the economy and interest rates affect high yield securities differently from other securities. For example, the prices of high yield bonds have been found to be less sensitive to interest rate changes than higher-rated investments, but more sensitive to adverse economic changes or individual corporate developments. 5/ Also, during an economic downturn or substantial period of rising interest rates, highly leveraged issuers may experience financial stress which

---

4/ U.S. General Accounting Office Report on High Yield Bonds: Issues Concerning Thrift Investments in High Yield Bonds (March 1989) at 3, 14, 17, 25-27 [hereinafter "1989 GAO Report"]. See Ricks, "Even 'Soft Landing' May Jolt 1 of 8 Junk Bonds," Wall St. J., July 12, 1989, at C1 (Study by Data Resources Inc. for the Alliance for Capital Access determined that the default rate on 573 junk-bond issuers would range from 11.7% to 14%).

5/ 1989 GAO Report at 24-25.

would adversely affect their ability to service their principal and interest payment obligations, to meet projected business goals, and to obtain additional financing. If the issuer of a bond defaulted, an investment company may incur additional expenses to seek recovery. In addition, periods of economic uncertainty and changes can be expected to result in increased volatility of market prices of high yield bonds and the investment company's asset value. Furthermore, in the case of high yield bonds structured as zero coupon or pay-in-kind securities, their market prices are affected to a greater extent by interest rate changes and thereby tend to be more volatile than securities which pay interest periodically and in cash.

Payment Expectations. Investment companies should disclose that high yield bonds present risks based on payment expectations. For example, high yield bonds may contain redemption or call provisions. If an issuer exercises these provisions in a declining interest rate market, the investment company would have to replace the security with a lower yielding security, resulting in a decreased return for investors. Conversely, a high yield bond's value will decrease in a rising interest rate market, as will the value of the investment company assets. If the investment company experiences unexpected net redemptions, this may force it to sell its high yield bonds, without regard to their investment merits, thereby decreasing the asset base upon which the investment company expenses can be spread and possibly reducing the investment company's rate of return.

Liquidity and Valuation. Investment companies should disclose that, to the extent that there is no established retail secondary market, there may be thin trading of high yield bonds, and the impact this may have on the investment company board of directors' ability to accurately value high yield bonds and the investment company's assets and on the investment company's ability to dispose of the bonds. 6/ Investment companies should

---

6/ In addition, if the investment company adopts specific investment policies to reduce liquidity risk of high yield bonds (such as, for example, only buying issues with a minimum number of market makers, limiting purchases to issues of more than a certain dollar amount, buying not more than a certain percentage or dollar amount of any issue, refraining from purchasing issues used to finance hostile takeovers, or restricting private placement purchases to those securities that the issuer obligates itself to pay to subsequently register so they can be publicly traded), then the investment company should disclose those investment policies and the likely impact of such policies on the

(continued...)

also disclose that adverse publicity and investor perceptions, whether or not based on fundamental analysis, may decrease the values and liquidity of high yield bonds, especially in a thinly traded market. Obviously, any subsequent material change in the nature of an investment company's portfolio liquidity from that previously disclosed would require the investment company to sticker its prospectus and/or statement of additional information.

In addition, if an investment company purchases illiquid or restricted high yield bonds, it should disclose that these securities may involve special registration responsibilities, liabilities and costs, and liquidity and valuation difficulties. 7/

Congressional Proposals. Investment companies should disclose the possible impact new laws and proposed new laws may have on the market for high yield bonds, e.g., new legislation requiring federally-insured savings and loan associations to divest their investments in high yield bonds and pending proposals designed to limit the use, or tax and other advantages, of high yield bonds which, if enacted, could have a material effect on the investment company's net asset value and investment practices.

Taxation. Investment companies must disclose special tax considerations associated with investing in high yield bonds structured as zero coupon or pay-in-kind securities. 8/ For example, the investment company reports the interest on these securities as income even though it receives no cash interest until the security's maturity or payment date. Also, the shareholders are taxed on this interest even if the investment

---

6/(...continued)
investment company's investment objective.

7/ The Commission has taken the position that open-end investment companies should not invest more than 10% of their assets in illiquid and restricted securities. See Investment Company Act Release Nos. 7220 and 7221 (June 9, 1972); Guides 11, 12 & 13 of Form N-1A. If an investment company purchases restricted securities, it must comply with footnote 6 of Item 12-12 of Regulation S-X, 17 CFR § 210.12-12, n.6, and with Section 404.04.c. of the Commission's Codification of Financial Reporting Policies, Fed. Sec. L. Rep. (CCH) ¶ 38,221.

8/ Items 6(g) & 20 of Form N-1A and Guide 30 thereto; Item 8(d) of Form N-2.

company does not distribute cash to them. Therefore, in order to pay taxes on this interest, shareholders may have to redeem some of their shares to pay the tax or the investment company may sell some of its assets to distribute cash to shareholders. These actions are likely to reduce the investment company's assets and may thereby increase its expense ratio and decrease its rate of return.

Credit Ratings. Guide 20 of Form N-1A provides specific disclosure guidance regarding investments in high yield bonds. It provides that an investment company that "seeks high income by investing in other than high-grade bonds [e.g., those receiving a Standard & Poor's rating of BBB or lower or a Moody's rating of Baa or lower] should concisely but clearly disclose in the prospectus the risks involved in such investments." In addition, if the investment company "chooses to use certain rating criteria in its prospectus disclosure, the [company] should disclose what would be the minimal rating which [it] would find acceptable." This would require the prospectus to describe the characteristics of the lowest rating and to include an appendix describing all the ratings and their respective characteristics.

Investment companies should also disclose the risks of applying credit ratings as a method for evaluating high yield bonds. For example, credit ratings evaluate the safety of principal and interest payments, not market value risk of high yield bonds. Also, since credit rating agencies may fail to timely change the credit ratings to reflect subsequent events, an investment company (either alone or in conjunction with its investment adviser) should be continuously monitoring the issuers of high yield bonds in its portfolio to determine if the issuers will have sufficient cash flow and profits to meet required principal and interest payments, and to assure the bonds' liquidity so the investment company can meet redemption requests. Also, an investment company should disclose whether it will retain a portfolio security whose rating has been changed. 9/

9/ A unit investment trust investing in high yield bonds must disclose any additional risks it faces because its portfolio is not actively managed. If a unit investment trust's net asset value drops and there are net redemptions, the unit investment trust may be forced to liquidate portfolio securities at a loss. If the redemptions are great enough, this could trigger a complete and unexpected liquidation of the unit investment trust before maturity, resulting in unanticipated losses for investors.

C. Asset Composition

The investment company prospectus should disclose the percentages of total investments represented by: (1) bonds rated by a nationally recognized statistical rating organization (NRSRO), separated into each rating category; (2) all unrated bonds as a group; and (3) unrated bonds which have been determined by the investment company's board of directors to be comparable in quality to rated bonds, separated into each NRSRO rating category. This information should be provided in tabular or narrative form based upon the weighted average ratings of all bonds held during the investment company's most recent fiscal year. This information should replace any discussion of "average ratings" of bonds in which the investment company invests. 10/ For subsequent fiscal years, any material deviations in the percentage figures from the previous fiscal year should be explained in future filings. This presentation more adequately presents the extent (degree) of risk included in a particular portfolio and gives objective information about the type of high yield bonds in which the investment company invests.

In addition to these issues, the Division staff may raise additional disclosure issues relating to investments in high yield bonds as necessary in the review of registration statements. Questions about specific investment company filings should be directed to the staff member(s) responsible for reviewing the document(s). General questions about this letter should be referred to Victor R. Siclari, Staff Attorney, Office of Disclosure Review, at (202) 272-3567.

Sincerely,

Carolyn B. Lewis
Assistant Director

10/ Use of an average rating, either in a registration statement or advertising, is inappropriate since it minimizes the significance of an investment company's holding of lower rated bonds.