

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

December 22, 1989

Craig S. Tyle
Associate General Counsel
Investment Company Institute
1600 M Street, N.W.
Washington, D.C. 20036

RE: Disclosure for Junk Bond Funds

Dear Mr. Tyle:

Following are the Division's comments on the ICI's November 1989 draft letter ("ICI Draft") which would ask for clarification of certain matters regarding the Division's letter of October 3, 1989 to junk bond funds. The October 3rd letter sets out the Division's views of the appropriate disclosure that should be included in registration statements of investment companies that invest in "other than high grade bonds." Our comments correspond to the sections in the ICI Draft.

Introduction

We would like your comments on the suggestion we made at our recent meeting that funds state that debt securities rated below investment grade are commonly known as "junk" bonds, rather than merely refer to them as "high yield" bonds.

I. COVERAGE

A. Investment Grade Bonds

We believe that the second sentence of the second paragraph should be modified to substitute "at a minimum" for "in general" and to state that bonds rated in the lowest category of investment grade debt "may have speculative characteristics," instead of "such bonds are more speculative than higher grade bonds." In addition, if a fund's policy is to invest in bonds rated no lower than investment grade, it should disclose whether it has a policy to retain or dispose of a bond whose rating drops below investment grade. Furthermore, a fund that invests in junk bonds also should disclose whether it has a policy to retain or dispose of a bond whose rating drops below the fund's minimum acceptable rating.

B. Inclusion in Prospectus

The Division believes the following guidelines should be followed to determine whether the required disclosure should be placed in the Prospectus or the Statement of Additional Information ("SAI").

1. If a fund invests, or anticipates investing, no more than 5% of its assets in junk bonds, it can merely identify the practice in the Prospectus and provide risk disclosure in the SAI.

2. If a fund invests, or intends to invest, up to 35% of its assets in junk bonds, the determination of the amount of disclosure in the Prospectus and SAI should be made in counsel's discretion consistent with the prominence of the investment in the fund's portfolio. See Guides 3, 20 and 21 of Form N-1A. For example, a concise summary in the Prospectus of pertinent risk factors may suffice in many cases.

   The fund should also include an appendix to the Prospectus detailing the description of ratings assigned by the rating organizations to portfolio securities. In the alternative, the fund may place the appendix in the SAI if the Prospectus provides a concise summary of the characteristics of ratings and the lowest rating assigned to a bond which the fund may purchase.

3. If a fund invests, or intends to invest, more than 35% of its assets in junk bonds, it should disclose in its Prospectus the investment risks of junk bonds and, if it uses rating criteria, the minimum acceptable rating in compliance with Guide 20. In addition, the fund should include in this disclosure a cross-reference to the appendix to its Prospectus detailing the description of ratings assigned by the rating organizations to portfolio securities.

Of course, if a fund deviates from its intent, the fund must appropriately modify its Prospectus disclosure.

C. Asset Composition

The asset composition disclosure should be included in the Prospectus of any fund that has invested more than 5% of its annual average assets in junk bonds. In addition, the fund should calculate its average annual asset composition based on time and dollar weighting; time weighting should be made no less frequently than monthly.

D. High Yield Municipal Bonds

The Division is unconvinced that non-investment grade municipal bonds are different from other junk bonds, except that they are exempt from registration and, therefore, would not involve the registration responsibilities, liabilities and costs upon resale as would other unregistered securities. The Division would, however, be willing to consider a registrant's argument supported by facts or analysis indicating that high-yield municipal securities do not share the same risk factors as junk bonds.

II. NATURE OF DISCLOSURE FOR HIGH YIELD BONDS

This part of the ICI Draft discusses a number of the specific disclosure items covered in the October 3rd letter. While we agree it may be useful to clarify these matters, we wish to stress that funds should not consider the discussion in the ICI Draft as establishing boiler plate disclosure with respect to these items. Funds should look to the October 3rd letter for a full discussion of the required disclosure. In addition, some topics covered in the October 3rd letter are missing or not fully covered in the ICI Draft, such as the section on the **Youth and Growth of the High Yield Bond Market.**

A. Disclosure That Should Appear in Most Registration Statements

The Division believes that the risk disclosure **should** appear as a separate section in the Prospectus. In several instances below, we would substitute "**should**" for "**may.**"

(1) Credit Risks and Risk of Default

The Division believes that the "registrant '**should**' state that achievement of its investment objective may be more dependent on the adviser's own credit analysis than is the case for higher quality bonds." Also, the fund should disclose whether it relies on the ratings assigned by credit agencies and/or analysis of the fund's investment adviser, and the extent of this reliance.

(3) Liquidity and Valuation

The first sentence should be modified to state that the illiquidity of the secondary market "may **adversely** affect the market price of, **and the ability of the fund's board of directors or trustees to value,** certain securities at certain times." In the second sentence, "**may**" should be replaced with "**should.**"

(4) Nature of Investment

"**May**" should be replaced with "**should.**" Also, the Division believes that the disclosure example in the second sentence would

serve well as a legend on the cover page of a prospectus of a fund investing more than 35% of its assets in junk bonds.

(5) Zeros and PIKs

The Division believes this section treats too summarily the Taxation section on page 5 of the October 3rd letter. At a minimum, a fund that invests in PIKs and Zeros should disclose the following. A fund accrues income with respect to these securities prior to the receipt of cash payments. To maintain its qualification for pass-through treatment under the tax law, a fund will be required to distribute income to shareholders and may have to dispose of its portfolio securities under disadvantageous circumstances to generate the cash, or may have to leverage itself by borrowing the cash, to satisfy these distributions.

B. Items That Should Be Disclosed Only In Certain Cases

(1) Proposed Legislation

The ICI Draft does not address the case of disclosure of legislation that has passed in only one house of Congress. We would expect to handle that circumstance on a case-by-case basis.

(2) Recovery Expenses on Defaulted Bonds

The Division believes that a fund should generally disclose that the expenses to recover its investment in a defaulted junk bond may adversely affect the fund's net asset value. The Division believes this disclosure is appropriate because of the speculative nature of junk bonds.

(3) Reliance on Ratings

The Division agrees with your statement, subject to our comment in II.A.(1), above (i.e., if a fund or its investment adviser relies on ratings assigned by the credit agencies in determining its investments, the fund should disclose the risks of relying on ratings and the credit agencies' analysis).

C. Other Items

The Division generally agrees that these items can be omitted, however, we do not adopt the first statement in II.C.(1). The Division believes that, because investment companies are, in the aggregate, significant investors in the junk bond market, any substantial net redemptions by shareholders in junk bond funds may distress the prices for junk bonds which would adversely affect a fund's net asset value. We do agree, however, that increased expense ratios due to lower asset levels is not a characteristic unique to junk bond funds.

III. ASSET COMPOSITION

As noted in I.C. above, the Division believes that the asset composition information should be included in the Prospectus of any fund that has invested more than 5% of its annual average assets in junk bonds.

If you have any questions, please call me at (202) 272-2039, Carolyn B. Lewis, assistant director, at (202) 272-2109 or Victor R. Siclari, staff attorney, at (202) 272-3567.

Sincerely,

Mary S. Podesta

Mary S. Podesta
Associate Director