

INFORMATIONAL

Bond Mutual Fund Volatility Ratings

SEC Approves New Rules Relating To Bond Mutual Fund Volatility Ratings

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KEY TOPICS

- Bond Mutual Fund Volatility Ratings
- NASD Rule IM-2110-5

Executive Summary

On February 29, 2000, the Securities and Exchange Commission (SEC) approved a National Association of Securities Dealers, Inc. (NASD[®]) rule change relating to bond mutual fund volatility ratings. New NASD Rule IM-2210-5 permits members and associated persons to include bond mutual fund volatility ratings in supplemental sales literature for an 18-month pilot period. Previously, NASD rules prohibited the use of bond fund volatility ratings. The rules are effective immediately and the pilot program will expire on August 31, 2001, unless extended or permanently approved by the NASD at or before such date.

The new rule permits the use of bond fund volatility ratings subject to certain conditions and disclosure requirements. In addition, NASD Rule 2210 regarding communications with the public was amended by adding new subparagraph (c)(3) to require supplemental sales literature containing bond mutual fund volatility ratings to be filed with the Advertising/Investment Companies Regulation Department (the Department) for review and approval at least 10 days prior to use.

Included with this *Notice* are Attachment A (text of the new rule and rule amendments) and Attachment B (sample Disclosure Statement).

Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Thomas M. Selman, Vice President, Investment Companies/Corporate Financing, NASD Regulation, Inc. (NASD RegulationSM) at (202) 728-8330; Thomas A. Pappas, Director, Advertising/Investment Companies Regulation, NASD Regulation, at

(202) 728-8330; or Robert J. Smith, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8451.

Background

Bond mutual fund volatility ratings describe the sensitivity of bond mutual fund portfolios to changing market conditions. Previously, NASD Regulation interpreted its rules to prohibit members from using bond mutual fund volatility ratings in supplemental sales literature. Supplemental sales literature refers to sales literature that is given to customers or prospective customers when, or after, a prospectus is given to them and supplements, but does not replace, the information contained in the prospectus. Supplemental sales literature is thus differentiated from mass media advertising or other sales material that is provided to prospective investors who have not yet received a prospectus. The prohibition derived from the concern that judgments of how a bond mutual fund may react to changes in various market conditions may be predictive of fund performance or misleading.¹

In *Notice to Members 96-84* (December 1996), NASD Regulation requested comment on the appropriateness of its interpretation prohibiting the use of bond mutual fund volatility ratings in supplemental sales literature. A majority of the commenters believed that NASD Regulation should allow members to use the volatility ratings in supplemental sales literature, and all of the commenters representing investor groups supported the goal of making accurate information regarding risk and volatility characteristics of bond mutual funds available to investors. A special subcommittee of the NASD

Regulation Board of Directors also recommended permitting the use of volatility ratings subject to certain conditions. In 1997, the NASD Regulation Board of Directors and the NASD Board of Governors approved the rule change and its filing with the SEC. The rule change was amended several times prior to approval by the SEC. In particular, the rule change was amended to remove the prohibition against using "a single symbol, number or letter" to describe a volatility rating. The rule change, as amended, was approved by the SEC on February 29, 2000.²

Description Of The New Rule Pilot Period

The new bond mutual fund volatility ratings rule, IM-2210-5, permits during an 18-month pilot period, ending August 31, 2001, the use of bond fund volatility ratings in supplemental sales literature, subject to certain conditions. As indicated in the SEC order approving the rule, during the 18-month pilot period the staff will consider whether:

- the rule has facilitated the dissemination of useful, understandable information to investors;
- the rule has prevented the dissemination of inappropriate or misleading information by members and associated persons;
- additional guidance concerning the use of certain terminology may be necessary;
- the rule should apply to in-house ratings;
- the rule should apply to all investment companies; and

- additional standards or guidance is needed to prevent investor confusion or minimize excessive variability among ratings of similar portfolios.

In addition, the staff will consider whether the use of a single symbol, number or letter describing a volatility rating, particularly those that are similar to or the same as credit ratings, might confuse investors. At the conclusion of its evaluation, NASD Regulation will determine whether to continue to permit use of the ratings; permit their use with modifications to the rule; or prohibit their use.

Definition Of Bond Mutual Fund Volatility Rating

Section (a) of the new rule defines the term "bond mutual fund volatility rating" to mean, in part, a description issued by an independent third party relating to the sensitivity of a portfolio of an open-end management investment company that invests in debt securities to changes in market conditions and the general economy, based on an evaluation of objective factors regarding the fund's current characteristics and its past performance. The definition applies only to bond mutual fund volatility ratings provided by an independent third party and only to open-end investment companies.

Prohibitions

Section (b) of the new rule permits members and associated persons to use a bond mutual fund volatility rating only in supplemental sales literature and only when the following requirements are satisfied.

- Subsection (b)(1) prohibits the use of a bond mutual fund volatility rating that uses the word "risk" to describe the rating.

- Subsection (b)(2) prohibits the use of a bond mutual fund volatility rating unless it incorporates the most recently available rating and is current to the most recent calendar quarter ended prior to use. This prohibition is intended to ensure that stale ratings are not provided to investors.

- Subsection (b)(3) prohibits the use of a bond mutual fund volatility rating that is not based exclusively on objective, quantifiable factors. This subsection also requires that the rating and the accompanying Disclosure Statement (as described below) be clear, concise, and understandable.

- Subsection (b)(4) prohibits the use of a bond mutual fund volatility rating unless the supplemental sales literature containing the rating conforms to the disclosure requirements in section (c) (as described below).

- Subsection (b)(5) prohibits the use of a bond mutual fund volatility rating unless the entity that issued the rating provides detailed disclosure on its rating methodology to investors through a toll-free telephone number, a web site, or both. Access to such supplemental information will enable investors to obtain answers to questions regarding the meaning of the rating or how it is calculated or derived.

Disclosure Requirements

Section (c) of the new rule requires that the following disclosures accompany any bond mutual fund volatility rating used in supplemental sales literature by members or associated persons of members.

- Subsection (c)(1) requires that supplemental sales literature containing a bond mutual fund volatility rating include a Disclosure Statement containing all the information required by the rule, but also permits the Disclosure Statement to contain any additional information that is relevant to an investor's understanding of the rating. Permitting the Disclosure Statement to contain additional relevant information could help elucidate the meaning of the rating.
- Subsection (c)(2) requires that supplemental sales literature containing a bond mutual fund volatility rating include all other current volatility ratings that have been issued with respect to the same fund. This subsection also permits information concerning multiple ratings to be combined in the Disclosure Statement, provided that the applicability of the information to each rating is clear. This serves the purpose of avoiding redundant and potentially confusing information. Subsection (c)(3) requires that all bond mutual fund volatility ratings be contained within the text of the Disclosure Statement.
- Subsections (c)(3)(A) - (B) of the new rule require that supplemental sales literature containing a bond mutual fund volatility rating disclose the name of the rating entity, the most current rating accompanied by the date of the

rating and, if there is any change in the current rating from the most recent prior rating, an explanation of the change. It is important for investors to see how a fund's rating may have changed and understand the reasons for the change.

- Subsection (c)(3)(C) of the new rule requires that supplemental sales literature containing a bond mutual fund volatility rating describe the rating in narrative form. Under subsections (c)(3)(C)(i) - (vii), the narrative description must also include:

(i) a statement that there is no standard method for assigning ratings;

(ii) a description of the criteria and methodologies used to determine the rating;

(iii) a statement that not all bond funds have volatility ratings;

(iv) a statement concerning whether consideration was paid in connection with obtaining the issuance of the rating;

(v) a description of the types of risks the rating measures, such as short-term volatility;

(vi) a statement that the portfolio may have changed since the date of the rating; and

(vii) a statement that there is no guarantee that the fund will continue to have the same rating or perform in the future as rated.

A sample Disclosure Statement is included in Attachment B to assist members in drafting Disclosure Statements that comply with the requirements of the rule.

Filing Requirement

The rule change also amends NASD Rule 2210 regarding communications with the public by adding new subsection (c)(3) to require sales literature containing bond mutual fund volatility ratings to be filed with the Department for review and approval at least 10 days prior to use. Members filing sales literature containing bond mutual fund volatility ratings also must provide any supplemental information requested by the Department pertaining to the rating that is in the member's possession. Members must complete any changes requested by the Department and await approval by the Department before using the sales literature.

The rules are effective immediately and will expire on August 31, 2001, unless extended or permanently approved by the NASD at or before such date.

Endnotes

¹NASD Conduct Rule 2210 prohibits the use by members and associated persons of information that is misleading; that contains exaggerated, unwarranted, or misleading statements or claims; or that predicts or projects investment results.

²See Securities Exchange Act Release No. 42476 (February 29, 2000).

ATTACHMENT A

(Note: Text of the new rule and rule amendments is underlined.)

IM-2210-5. Requirements for the Use of Bond Mutual Fund Volatility Ratings

(This rule will expire on August 31, 2001, unless extended or permanently approved by the Association at or before such date.)

(a) Definition of Bond Mutual Fund Volatility Ratings

For purposes of this Rule and any interpretation thereof, the term "bond mutual fund volatility rating" is a description issued by an independent third party relating to the sensitivity of the net asset value of a portfolio of an open-end management investment company that invests in debt securities to changes in market conditions and the general economy, and is based on an evaluation of objective factors, including the credit quality of the fund's individual portfolio holdings, the market price volatility of the portfolio, the fund's performance, and specific risks, such as interest rate risk, prepayment risk, and currency risk.

(b) Prohibitions on Use

Members and persons associated with a member may use a bond mutual fund volatility rating only in supplemental sales literature and only when the following requirements are satisfied:

- (1) The rating does not identify or describe volatility as a "risk" rating.
- (2) The supplemental sales literature incorporates the most recently available rating and

reflects information that, at a minimum, is current to the most recently completed calendar quarter ended prior to use.

(3) The criteria and methodology used to determine the rating must be based exclusively on objective, quantifiable factors. The rating and the Disclosure Statement that accompanies the rating must be clear, concise, and understandable.

(4) The supplemental sales literature conforms to the disclosure requirements described in paragraph (c).

(5) The entity that issued the rating provides detailed disclosure on its rating methodology to investors through a toll-free telephone number, a web site, or both.

(c) Disclosure Requirements

(1) Supplemental sales literature containing a bond mutual fund volatility rating shall include a Disclosure Statement containing all the information required by this Rule. The Disclosure Statement may also contain any additional information that is relevant to an investor's understanding of the rating.

(2) Supplemental sales literature containing a bond mutual fund volatility rating shall contain all current bond mutual fund volatility ratings that have been issued with respect to the fund. Information concerning multiple ratings may be combined in the Disclosure Statement, provided that the applicability of the information to each rating is clear.

(3) All bond mutual fund volatility ratings shall be contained within

the text of the Disclosure Statement. The following disclosures shall be provided with respect to each such rating:

(A) the name of the entity that issued the rating;

(B) the most current rating and date of the current rating, with an explanation of the reason for any change in the current rating from the most recent prior rating;

(C) a description of the rating in narrative form, containing the following disclosures:

(i) a statement that there is no standard method for assigning ratings;

(ii) a description of the criteria and methodologies used to determine the rating;

(iii) a statement that not all bond funds have volatility ratings;

(iv) whether consideration was paid in connection with obtaining the issuance of the rating;

(v) a description of the types of risks the rating measures (e.g., short-term volatility);

(vi) a statement that the portfolio may have changed since the date of the rating; and

(vii) a statement that there is no guarantee that the fund will continue to have the same rating or perform in the future as rated.

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**2200. COMMUNICATIONS
WITH CUSTOMERS AND THE
PUBLIC**

**2210. Communications with
the Public**

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**(c) Filing Requirements and
Review Procedures**

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(3) Sales literature concerning
bond mutual funds that include or

incorporate bond mutual fund
volatility ratings, as defined in
Rule IM-2210-5, shall be filed
with the Department for review at
least 10 days prior to use (or
such shorter period as the
Department may allow in
particular circumstances) for
approval and, if changed by the
Association, shall be withheld
from publication or circulation
until any changes specified by
the Association have been made
or, if expressly disapproved, until
the sales literature has been
refiled for, and has received,

Association approval. Members
are not required to file advertising
and sales literature which have
previously been filed and which
are used without change. The
member must provide with each
filing the actual or anticipated
date of first use. Any member
filing sales literature pursuant to
this paragraph shall provide any
supplemental information
requested by the Department
pertaining to the rating that is
possessed by the member.

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ATTACHMENT B**Sample Disclosure Statement**

The volatility rating for this fund issued by *[XYZ rating entity]* (XYZ) is: *[insert narrative rating]*. The rating seeks to measure *[description of what risks the rating measures, e.g., "how the value of the fund's current portfolio might respond to changing market conditions"]*. XYZ arrived at its rating in the following way: *[insert description of methodology]*. There is no standard method for determining volatility ratings. The rating is current as of *[date]*. The fund's portfolio may have changed since this date and there is no guarantee that the fund will continue to have the same rating or perform in the future as rated. Not all bond mutual funds have volatility ratings and those that do may have paid for them. The fund *[did/did not pay for]* the volatility rating issued by XYZ. The fact that a fund has a rating is not an indication that it is more or less risky or volatile than a fund that does not. If you would like more specific information on the rating or the methodology used to determine the rating, call XYZ at (800) 000-000 or visit XYZ's web site at *[insert web site address]*.

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