

# Notice to Members

DECEMBER 2003

REQUEST FOR COMMENT

ACTION REQUESTED BY JANUARY 23, 2004

## SUGGESTED ROUTING

Advertising/Investment Companies  
Executive Representatives  
Legal & Compliance  
Mutual Fund  
Senior Management

## KEY TOPICS

Advertising  
Mutual Fund Expenses  
Investment Companies  
NASD Rules 2210 and 2211

## Disclosure of Mutual Fund Expense Ratios in Performance Advertising

NASD Requests Comment on Proposed Amendments to Rules 2210 (Communications With the Public) and 2211 (Institutional Sales Material); **Comment Period Expires January 23, 2004**

### Executive Summary

NASD proposes to amend Rules 2210 and 2211 to require all member communications with the public that contain investment company performance information ("performance advertising") to present specified information about the fund's expenses and performance in a prominent text box. These new requirements would improve investor awareness of the costs of buying and owning a mutual fund, facilitate comparisons among funds, and make presentation of standardized performance more prominent. NASD's proposal would require that:

- ▶ All performance advertising contain a text box that sets forth the fund's (a) standardized performance information; (b) maximum sales charge; and (c) annual expense ratio; and
- ▶ The text box information be presented in type size at least as large as non-standardized performance, if non-standardized performance information is included.

### Questions/Further Information

Questions concerning this *Notice* may be directed to Angela C. Goelzer, Counsel, Investment Company Regulation, Regulatory Policy and Oversight, at (202) 728-8120.

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## Request for Comment

NASD requests comment on the proposed amendments to Rules 2210 and 2211 described in this *Notice*. Members wishing to comment must make a submission that is received by January 23, 2004. Members and interested persons can submit their comments using the following methods:

- ▶ Mailing in written comments;
- ▶ E-mailing written comments to [pubcom@nasd.com](mailto:pubcom@nasd.com); or
- ▶ Submitting comments online at the NASD Web Site ([www.nasd.com](http://www.nasd.com)).

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney  
NASD  
Office of the Corporate Secretary  
1735 K Street, NW  
Washington, D.C. 20006-1500

**Important Notes:** The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web Site. Generally, comments will be posted on the NASD Web Site one week after the end of the comment period. See *Notice to Members 03-73*.

Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

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## Background

The content of performance advertising is governed primarily by SEC and NASD rules.<sup>1</sup> NASD Rules 2210 and 2211 set forth NASD standards, and Rule 482 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act of 1940 set forth SEC requirements. These rules help to ensure that these communications are fair, balanced, and not misleading.

### 1. NASD Rules 2210 and 2211

Rule 2210 governs communications with the public, including performance advertising. Rule 2210(d) provides that all member communications with the public must be based on principles of fair dealing and good faith, and should provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. The rule further provides that “no member may omit any material fact or qualification” if the communication would cause the material to be misleading. In addition, Rule 2210(e) requires that members’ public communications comply with all applicable rules of the SEC.

NASD applies the standards of Rule 2210 and applicable SEC rules through the filing requirements and review procedures of Rule 2210(c). Generally, all advertisements and sales literature concerning registered investment companies must be filed with NASD within ten days of first use or publication.<sup>2</sup> NASD staff reviews each piece to ensure that it is consistent with applicable SEC and NASD rules.

NASD has not interpreted Rule 2210 to require performance advertising to include a fund’s expense ratio. In addition, NASD does not have specific rules about how standardized performance information must be presented in all performance advertising.

Rule 2211 governs institutional sales material and correspondence. Rule 2211 was adopted to create a separate rule for these communications and to present the requirements that apply to these communications in a more easily understandable format.<sup>3</sup> Rule 2211(d)(1) provides that all institutional sales material and correspondence are subject to the content standards of Rule 2210(d)(1) and the applicable Interpretive Materials under Rule 2210.

### 2. SEC Rules 482 and 34b-1

Rule 482 and Rule 34b-1 permit an investment company to include performance information in sales material. If performance information is included, the SEC requires disclosure of the fund’s maximum sales charges and its average annual total return for the most recent 1, 5, and 10-year periods, as of the most recent calendar quarter. The total return must be calculated according to standards set forth by the SEC, taking into account sales charges and expenses. These returns are generally referred to as standardized performance. These rules also require that the standardized performance figures be presented at least as prominently as any non-standardized performance information included in the sales material.

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On September 24, 2003, the SEC adopted amendments to Rule 482 and 34b-1 to require mutual fund sales material to convey balanced information to investors, particularly with regard to past performance. The amendments require a fund that advertises performance to make available, by toll-free telephone or Web site, standardized performance returns that are current to the most recent month-end. The amendments also require that performance advertisements include a legend alerting investors that past performance does not guarantee future results, and that current performance may be higher or lower than the performance quoted. These advertisements also must now highlight the availability of information in the prospectus about a fund's objectives, risks, and expenses. The amendments do not specifically address the manner in which standardized performance information must be presented or require the inclusion of a fund's expense ratio in performance advertising.

## The Proposal

Congress, regulators, and investors increasingly have expressed concerns over the need for improved disclosure of fund expenses. These concerns are fueled in part by the increased prominence of mutual funds as an investment vehicle for millions of middle-class American investors. Approximately 95 million shareholders in 54.2 million U.S. households own mutual funds, figures that represent about half of all American households.<sup>4</sup>

The focus on fund fees is important because fees can have a dramatic impact on an investor's return. With these considerations in mind, NASD proposes two improvements to performance advertising regulation. First, NASD proposes to require disclosure of a fund's annual expense ratio in performance advertising. Second, NASD proposes to provide more specific standards to ensure that standardized performance information is presented with sufficient prominence and clarity.

By amending Rule 2210 to require the inclusion of a fund's expense ratio in performance advertising, NASD will help to ensure that each investor whose purchase of mutual fund shares may be influenced by performance advertising will be made aware of the fees charged to purchase and own the fund. By requiring that standardized performance information be presented prominently in a text box along with the fund's maximum sales charge and annual expense ratio, the amendments will ensure that these key items of information are presented in a manner that promotes investor awareness. They also will ensure that standardized performance information is presented at least as prominently as non-standardized performance.

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The proposal would amend Rule 2210 to require that any investment company communications with the public that include performance information permitted by Rule 482 or Rule 34b-1 also disclose:

- ▶ The standardized information required by Rule 482 and Rule 34b-1;
- ▶ The fund's maximum sales load; and
- ▶ The fund's annual operating expenses.

The rules would require that this information be presented in a prominent text box in a type size at least as large as that used to present non-standardized performance information. NASD recognizes that standardized mutual fund performance information already reflects the fund's sales load and expenses. Indeed, the disclosure required by this proposal would state this fact. NASD believes that, just as presentation of the maximum sales load informs customers about one-time charges that they may incur if they purchase the fund, disclosure of the expense ratio would provide investors with critical information about the annual expenses that they would incur. Consequently, the proposal would require disclosure of the expense ratio as well as the maximum sales load, separate and apart from the disclosure of standardized performance.

Finally, the rules would provide that, in the case of materials delivered through an electronic medium, the new disclosure requirements may be satisfied by presenting the information required in a manner that is intended to draw investor attention to the disclosures. In the case of radio, television, or video performance advertising, the information required must be given prominence equal to that given to non-standardized performance information, if applicable.

NASD also is proposing an amendment to Rule 2211(d)(1) to reflect that institutional sales material and correspondence also would be subject to these proposed content standards in new Rule 2210(d)(3).

NASD also seeks comment on possible alternatives to the disclosure proposed in this *Notice to Members*. Should the proposal be expanded to require disclosure of other types of information? Instead of disclosure of a fund's expense ratio, should NASD require disclosure of the actual dollar amount of expenses incurred by a hypothetical shareholder in the fund (e.g., dollar amount of expenses per a \$10,000 investment)?

NASD also seeks comment on whether the requirements in the proposal should be extended to certain types of investment company sales material that does not present performance information. For example, in December 1998, NASD notified members that advertisements and sales material that refer to a fund as "no-load" or part of a "no-load" family of funds must disclose the fact that other fees and expenses apply to an investment in the fund and are described in the fund's current prospectus.<sup>5</sup> Would investors be better served if all sales material that refers to a fund as "no-load" were required to disclose the fund's annual expense ratio?

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## Endnotes

- 1 Performance advertising also is subject to the antifraud provisions of the federal securities laws.
- 2 Rule 2210(c)(1). Rule 2210(c)(2) requires that such materials be filed at least ten days *prior* to first use if they include performance rankings or performance comparisons of the fund with other investment companies if the ranking or comparison category is not generally published or is the creation of the fund or a fund affiliate.
- 3 Rule 2211, effective November 3, 2003, was adopted as part of NASD's modernization of its advertising rules earlier this year. See *Notice to Members 03-38*.
- 4 See *2003 Mutual Fund Fact Book*, Investment Company Institute. In contrast, only 6 percent of U.S. households owned funds in 1980.
- 5 *Notice to Members 98-107*.

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## ATTACHMENT A

### TEXT OF PROPOSED AMENDMENTS

Rule 2210 is amended by adding the following new language at the end of paragraph (d):

(d)(3) Standards Applicable to Investment Company Communications with the Public

(A) Communications with the public that include investment company performance data as permitted by Rule 482 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act of 1940 must disclose:

- (i) the standardized performance information mandated by Rule 482 and Rule 34b-1;
- (ii) the maximum sales charge imposed on purchases or the maximum contingent deferred sales charge, computed in accordance with Item 3 of Form N-1A under the Investment Company Act of 1940 ("Item 3"); and
- (iii) annual fund operating expenses, computed as a percentage of total net assets in accordance with Item 3, as of the most recent calendar quarter.

(B) The information described in subparagraph (A) must be set forth in:

- (i) a prominent text box that contains only the information required by paragraph (A); and
- (ii) a type size at least as large as that used to present any non-standardized performance.

(C) In a communication delivered through an electronic medium, the requirements of subparagraph (B) may be satisfied by presenting the information in a manner that is intended to draw investor attention to it. In a radio, television or video advertisement, the information must be given emphasis equal to that given to any non-standardized performance information.

Rule 2211(d)(1) is amended as follows (new text is underlined):

(1) All institutional sales material and correspondence are subject to the content standards of Rule 2210(d)(1) and (d)(3) and the applicable Interpretive Materials under Rule 2210.

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## ATTACHMENT B

### Sample Disclosure

"[performance numbers.] These performance numbers reflect the deduction of the fund's maximum [front-end/back-end] sales charge and annual expenses. The fund's current maximum [front-end/back-end] sales charge is \_\_% and the fund's current annual expenses are \_\_% of the fund's net assets.