

Notice to Members

AUGUST 2003

SUGGESTED ROUTING

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

KEY TOPICS

Bond Mutual Fund Volatility Ratings
NASD IM-2210-5
NASD Rule 2210

INFORMATIONAL

Bond Mutual Fund Volatility Ratings

SEC Approves Extension of Pilot Relating to Bond Mutual Fund Volatility Ratings

Executive Summary

On August 7, 2003, NASD filed with the Securities and Exchange Commission (SEC) a proposed rule change to extend for two years the effectiveness of NASD rules that govern the use of bond mutual fund volatility ratings in member sales material. The rule change was effective upon filing. NASD Interpretive Material 2210-5 permits members and associated persons to include bond mutual fund volatility ratings in supplemental sales literature, subject to certain conditions. NASD Rule 2210(c)(3) requires supplemental sales literature containing bond mutual fund volatility ratings to be filed with the Advertising Regulation Department (the Department) for review and approval at least 10 days prior to use.

On February 29, 2000, the SEC approved IM-2210-5 and Rule 2210(c)(3) on an interim 18-month pilot basis. In August 2001, NASD extended the pilot for two-years, until August 31, 2003. The most recent rule filing extends these rules' effectiveness for an additional two years, until August 31, 2005.

Included with this *Notice* is Attachment A (text of rule amendments).

Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Joseph P. Savage, Counsel, Investment Companies Regulation, Regulatory Policy and Oversight, at (240) 386-4534, or Philip A. Shaikun, Associate General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

Background

On February 29, 2000, the SEC approved the adoption of NASD Interpretive Material 2210-5, which permits members and their associated persons to include bond fund volatility ratings in supplemental sales literature (mutual fund sales material that is accompanied or preceded by a fund prospectus). The SEC also approved at that time new NASD Rule 2210(c)(3), which sets forth the filing requirements and review procedures applicable to sales literature containing bond mutual fund volatility ratings. Previously, NASD staff interpreted NASD rules to prohibit the use of bond fund volatility ratings in sales material.

IM-2210-5 permits the use of bond fund volatility ratings only in supplemental sales literature and only if certain conditions are met:

- ◆ The word “risk” may not be used to describe the rating.
- ◆ The rating must be the most recent available and be current to the most recent calendar quarter ended prior to use.
- ◆ The rating must be based exclusively on objective, quantifiable factors.
- ◆ The entity issuing the rating must provide detailed disclosure on its rating methodology to investors through a toll-free telephone number, a Web site, or both.
- ◆ A disclosure statement containing all of the information required by the rule must accompany the rating. The statement must include such information as the name of the entity issuing the rating, the most current rating and the date it was issued, and a description of the rating in narrative form containing certain specified disclosures.

Rule 2210(c)(3) requires members to file bond mutual fund sales literature that includes or incorporates volatility ratings with the Department at least 10 days prior to use for Department approval. If the Department requests changes to the material, the material must be withheld from publication or circulation until the requested changes have been made or the material has been re-filed and approved. For a more complete description of IM-2210-5 and Rule 2210(c)(3), please see *Notice to Members 00-23* (April 2000).

Extension of Pilot Period

The SEC originally approved IM-2210-5 and new Rule 2210(c)(3) on an 18-month trial basis, until August 31, 2001, to provide NASD an opportunity to assess whether the rule had facilitated the dissemination of useful, understandable information to investors, and whether it had prevented the dissemination of inappropriate and misleading information.

During the initial pilot period, the Department received very few filings pursuant to these provisions. In general, these filings have met the requirements of IM-2210-5. Although these filings generally met the rule's requirements, the staff did not believe that it had received a sufficient number of filings to evaluate adequately the rule's effectiveness. Accordingly, in July 2001, NASD, pursuant to a rule filing with the SEC, extended the pilot for two years.¹ The extended period expires on August 31, 2003.

The Department has continued to receive very few filings under these rules during the extended pilot period. During the entire period from February 2000, when the rule was first approved, until the present, NASD has received a total of 41 submissions from three NASD members. In general, these filings met the requirements of IM-2210-5. However, the staff still does not believe that it has received a sufficient number of filings to adequately evaluate the rule's effectiveness.

In this regard, NASD notes that, because of the low interest rates over the last two years, bond mutual funds may have had little reason to distribute sales material that contains volatility ratings.

Accordingly, NASD is proposing to extend the expiration date of IM-2210-5 and Rule 2110(c)(3) for an additional two years, until August 31, 2005, to allow more filings to be made. The SEC recently published notice of this extension in the Federal Register.² Before this period expires, the staff will evaluate the rule and determine whether to recommend that the rule be eliminated, modified, or permanently approved in its current form.

Endnotes

- 1 See SEC Release No. 34-44737 (Aug. 22, 2001), 66 Fed. Reg. 45350 (Aug. 28, 2001) (SR-NASD-2001-49).
- 2 See SEC Release No. 34-48353 (Aug. 15, 2003), 68 Fed. Reg. 50568 (Aug. 21, 2003) (SR-NASD-2003-126).

ATTACHMENT A – RULE TEXT

New text is underlined and deleted text is bracketed.

2210. Communications with the Public

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(c) Filing Requirements and Review Procedures

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(3) Sales Literature Containing Bond Fund Volatility Ratings

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 business days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changed by NASD, shall be withheld from publication or circulation until any changes specified by NASD have been made or, if expressly disapproved, until the sales literature has been refiled for, and has received, NASD 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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IM-2210-5. Requirements for the Use of Bond Mutual Fund Volatility Ratings

(This rule and Rule 2210(c)(3) will expire on August 31, [2003] 2005, unless extended or permanently approved by [the Association] NASD 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.