

NASD NOTICE TO MEMBERS 97-47

NASD Regulation
Requests Comment On
Presentation Of Related
Performance Information;
**Comment Period
Expires September 29,
1997**

Suggested Routing

- ☒ Senior Management
- ☒ Advertising
- ☐ Corporate Finance
- ☐ Government Securities
- ☐ Institutional
- ☐ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☒ Mutual Fund
- ☐ Operations
- ☐ Options
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☐ Trading
- ☐ Training

Executive Summary

In the following document, NASD Regulation, Inc. (NASD RegulationSM) requests public comment concerning the potential benefits to investors of allowing the presentation of Related Performance Information in mutual fund (and, where applicable, variable product) sales material. NASD Regulation also requests comment on the potential investor protection concerns associated with the presentation of Related Performance Information in mutual fund (and where applicable, variable product) sales material.

Questions concerning this *Request For Comment* should be directed to Thomas M. Selman, Director, Advertising/Investment Companies Regulation, at (202) 728-8330 or Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 726-8176.

Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley
Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, D.C. 20006-1500;

or e-mailed to:
pubcom@nasd.com

Comments must be received **by September 29, 1997**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation, Inc. Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

NASD REGULATION REQUEST FOR COMMENT 97-47

Executive Summary

A) Recent No-Action Letters of the Division of Investment Management

The SEC's Division of Investment Management recently issued a series of "no-action letters" that essentially permit mutual funds to present a range of performance information in their sales material and/or prospectuses, in specific factual circumstances and subject to specific conditions.¹ The letters thus permit funds to present the performance of:

- an insurance company separate account, common trust fund or private investment company that had been converted into the offered mutual fund ("predecessor performance");
- private or institutional accounts that are managed by the mutual fund's adviser ("private account performance");
- investment companies that are managed by the mutual fund's adviser;
- a mutual fund that was previously managed by the offered fund's portfolio manager ("manager performance"); and
- a mutual fund from which the offered fund had been "cloned" ("clone performance").

(This *Request For Comment* will refer to these types of performance information as "Related Performance Information.")

The Division's no-action letters were based on representations that are designed to ensure that Related Performance Information is not presented in a misleading manner. For example, the letters generally require that the mutual fund and the accounts to which the Related Performance Information relates are managed in a "substantially similar" manner. The

letters also require that Related Performance Information be accompanied by various types of disclosure, including disclosure concerning "all material differences" between a mutual fund and the accounts to which the Related Performance Information refers and "any other disclosure that may be necessary to ensure that the [Related Performance Information] is not presented in a misleading manner." The Division's letters state that the NASD[®] Conduct Rules impose standards on mutual fund sales material separate from the SEC's rules, and the Division reached no conclusion concerning whether the presentation of Related Performance Information under the conditions imposed by the letters would comply with the NASD Conduct Rules.

B) Regulation of Mutual Fund Advertising by the SEC and NASD Regulation

The Division's no-action letters reflect the complementary nature of advertising regulation by the SEC and the National Association of Securities Dealers, Inc. (NASD). The SEC's advertising rules establish general standards to ensure that mutual fund sales material is not misleading. The SEC may monitor compliance with these standards in its mutual fund inspections and examinations.

NASD Regulation, Inc. (NASD RegulationSM) has primary responsibility for reviewing actual sales material filed by NASD members and for developing specific requirements that address practical issues that these sales pieces may raise. These requirements, which are independent of the SEC's advertising rules but are subject to SEC oversight, are designed to ensure that sales material does not mislead or confuse investors, that it provides a sound basis for an investment decision, that

it is accurate and that it makes a fair and balanced presentation. Depending upon the nature of the practical issues that certain types of information are found to raise in the filings review process, NASD Regulation may impose conditions or even prohibit the use of these types of information by NASD members, even if presentation of this information would not violate the SEC's general antifraud provisions.

This system of regulation has permitted mutual funds to develop innovative marketing materials that provide useful and relevant information to investors. At the same time, it has best ensured that the presentation of this information complies with high standards of full and fair disclosure.

C) NASD Regulation's Consideration of Related Performance Information

Since 1993, the Division has permitted a mutual fund to include relevant private account performance in its supplemental sales literature and prospectus during the fund's first year of operations. (The Division's recent letters eliminated this one-year restriction and expanded the relief to Rule 482 advertisements.) NASD Regulation has not, however, permitted the presentation of private account performance or most other types of Related Performance Information in supplemental sales literature or Rule 482 advertisements.²

In light of the Division's recent no-action letters and the apparent public interest in the potential benefits and concerns with the presentation of Related Performance Information in mutual fund advertising, NASD Regulation has commenced a comprehensive examination of the issues related to such presentations. NASD Regulation intends to consider the practical application of its rules to the presentation of Related Performance

Information in actual filings, and whether more specific direction concerning the presentation of Related Performance Information — or even a prohibition on certain uses of this information — would be necessary to ensure that investors are not misled or confused.

The Board of Directors of NASD Regulation has determined that NASD Regulation will maintain its current positions with respect to the presentation of Related Performance Information in mutual fund and variable product sales material during NASD Regulation's review of these issues.

NASD Regulation recognizes that Related Performance Information might be useful to investors. Mutual fund sales material often describes the investment experience of the fund's investment adviser and portfolio manager. Related Performance Information might provide an additional basis upon which an investor could evaluate the investment acumen and expertise of the adviser or portfolio manager. NASD Regulation requests public comment concerning the potential benefits to investors of allowing the presentation of Related Performance Information in mutual fund (and, where applicable, variable product) sales material.

NASD Regulation also requests comment on the potential investor protection concerns associated with the presentation of Related Performance Information in mutual fund (and where applicable, variable product) sales material. Should NASD Regulation continue to prohibit the presentation of some or all types of Related Performance Information? For example, would the risks that a mutual fund sponsor might tend to select private accounts that attained superior performance (and exclude those that did not) justify a prohibition on the presentation of private account

performance? Would the presentation of manager performance necessarily mislead investors into believing that this performance was attributable solely to the efforts of the portfolio manager, even when it was largely attributable to the personnel and resources of the fund's investment adviser?

NASD Regulation also requests comment on what, if any, specific disclosure requirements we should adopt to best ensure that the presentation of Related Performance Information does not mislead or confuse investors. In addition to specific disclosure requirements, NASD Regulation is interested in whether specific guidance concerning the calculation of Related Performance Information in sales material would be appropriate and feasible. Should NASD Regulation impose objective criteria that might reduce the effects of any subjective determinations involved in the calculation of this information? If so, what should these criteria be and how could they be enforced through the filings review process?

NASD Regulation is also interested in what, if any, specific standards should be adopted to discourage the "incubation" of several private funds and the subsequent conversion of the fund with superior performance into a public mutual fund. Finally, NASD Regulation is interested in what, if any, specific standards should be imposed to help ensure that investors can compare a wide range of performance data. For example, NASD Regulation could mandate uniform standards concerning the presentation of different types of Related Performance Information.

Questions concerning this *Request For Comment* should be directed to Thomas M. Selman, Director, Advertising/Investment Companies Regulation, at (202) 728-8330 or Robert J. Smith, Senior Attorney, Office of

General Counsel, NASD Regulation, at (202) 726-8176.

II. Related Performance Information

In the past two years, the SEC's Division of Investment Management has issued a series of no-action letters that permit mutual funds to present Related Performance Information in their prospectuses or sales material under certain conditions including, in each case, that management of the funds and the related accounts would be substantially similar.

MassMutual Institutional Funds (pub. avail. September 28, 1995) essentially permitted mutual funds that had been converted from unregistered insurance company separate accounts to include predecessor performance in their prospectuses and sales material, adjusted to reflect the funds' fees and expenses. The Division stated that its analysis also would apply to the conversion of private investment companies and common trust funds into mutual funds.

Two additional letters, *Nicholas-Applegate Mutual Funds* (pub. avail. August 6, 1996 and February 7, 1997), essentially permitted mutual funds to include private account performance in their prospectuses and sales material, subject to certain conditions. Until the staff issued these letters, the Division had only permitted use of this information in prospectuses and supplemental sales literature during the first year of a fund's existence. The *Nicholas-Applegate* letters imposed no one-year restriction, and extended relief to mutual fund performance advertisements.

Bramwell Growth Fund (pub. avail. August 7, 1996) essentially permitted a mutual fund to include manager performance in its prospectus, subject to certain conditions. The Divi-

sion had not previously stated that such information could be included in a mutual fund prospectus.

ITT-Hartford Mutual Funds (pub. avail. February 7, 1997) essentially permitted mutual funds to include clone performance in their sales material. This performance information related to other investment companies managed by the same adviser and subadviser and that served as funding vehicles for variable insurance products. The mutual funds were "modeled" after the insurance funds.

GE Funds (pub. avail. February 7, 1997) essentially permitted mutual funds to include in their sales material the performance of other registered investment companies and institutional private accounts managed by the funds' adviser or its affiliate. The adviser and affiliate had in common "virtually all of their investment professionals."

III. Potential Benefits and Concerns With Related Performance Information

A) Potential Benefits

Today many mutual funds describe the investment acumen and expertise of their investment adviser or portfolio manager in their sales material. Mutual funds may, for example, identify the portfolio manager and describe the manager's experience, and may describe the assets that the investment adviser has under management and the length of time that the adviser has offered investment advice. NASD Regulation recognizes that this information can be helpful to investors and has not objected to its use provided that it is presented in a way that is not misleading.

Related Performance Information apparently is intended to provide

additional information on the basis of which to evaluate the skills and experience of the adviser or portfolio manager. NASD Regulation requests comment on the potential benefits to investors of permitting the presentation of Related Performance Information in mutual fund and variable product sales material. Commenters are asked to address the following issues, distinguishing whenever necessary between different types of Related Performance Information:

- Does Related Performance Information provide a "sound basis" for making an investment decision for purposes of NASD Conduct Rule 2210?
- To what extent do investors want or need this information?
- Precisely how would sponsors of mutual funds and variable products propose to present this information in sales material?
- What legal or practical limitations might there be on providing those benefits (e.g., litigation risks; space limitations on required disclosure)?
- What conditions on the use of Related Performance Information would ensure that it will be used for these beneficial purposes?
- For example, should NASD Regulation permit the use of Related Performance Information only to advertise mutual funds and variable products that have not established their own performance records?
- Are the benefits from making Related Performance Information available to investors so significant that NASD Regulation should *require* the use of this information in mutual fund and variable product sales material?

B) Potential Concerns

The SEC and the NASD have long recognized that the presentation of mutual fund and variable product performance data in sales material, while compelling to many investors, can also present special risks if not adequately regulated. In 1988, for example, the SEC amended Rule 482 and adopted Rule 34b-1 to impose uniform standards on the calculation and presentation of performance data in mutual fund sales material because the calculation methods previously in use did not produce data that investors could compare and may have distorted actual performance. SEC Rule 156 describes some conditions under which representations about investment performance could be misleading. NASD Conduct Rule 2210 similarly prohibits members from predicting or projecting investment results or from implying that past gain or income will be repeated.

NASD Regulation requests comment on what, if any, specific conditions on the use of Related Performance Information in mutual fund and variable product sales material could best ensure that this information would not confuse or mislead investors. Commenters should distinguish whenever possible between different types of Related Performance Information, and should describe any regulatory conditions that might address perceived investor protection concerns. Commenters also should indicate whether the potential concerns with the use of Related Performance Information might depend upon where it appears (*e.g.*, in advertisements or supplemental sales material).

NASD Regulation also requests comment on the following specific issues:

1) Should NASD Regulation Impose Specific Disclosure Standards on the Presentation of Related Performance

Information?

The Division's no-action letters were explicitly conditioned upon general disclosure standards that are designed to prevent a misleading presentation of Related Performance Information. In addition, requesters represented that they would present the information according to certain specific criteria (*e.g.*, presentation of predecessor performance that reflects the advertised fund's fees and expenses).

NASD Regulation requests comment concerning what, if any, specific disclosure requirements we should apply in our filings review program. For example, should NASD Regulation impose conditions on the use of Related Performance Information similar to the requirements of SEC Rule 482 with respect to mutual fund performance information (*e.g.*, prohibition of the use of distribution rates for related accounts; a requirement that Related Performance Information be current as of the most recent calendar quarter; mandated presentation of one-, five- and ten-year total return for the related accounts)? Should NASD Regulation require that Related Performance Information reflect the fund level expenses, sales charges and shareholder account fees that investors would incur if they were to invest in the mutual fund?

In addition, the Division's no-action letters were partially based on a representation that sales material would describe all material differences between the related accounts and the offered mutual fund. Should NASD Regulation require specific types of disclosure to ensure that investors are informed about these differences?

The SEC and the NASD have recognized that a determination concerning whether information is misleading may partially depend

upon whether an investor is likely to understand the information and recognize its limitations given the investor's level of financial sophistication and investment experience. Moreover, NASD Conduct Rule 2210 states, "A complex or overly technical explanation may be worse than too little information." What conditions, if any, should NASD Regulation place on the presentation of Related Performance Information to ensure that the average investor will understand the information and its limitations?

Should any conditions apply to the use of graphs or other illustrations of the Related Performance Information or comparisons of the related accounts to a "peer group"?

2) Should NASD Regulation Impose Standards on the Calculation of Related Performance Information?

NASD Regulation requests comment on the extent to which we should (or even could) regulate the calculation of Related Performance Information in our filings review program. While NASD Regulation could review the disclosure provided by any sales piece, other issues related to the calculation of this information might not be as susceptible to review.

Under the facts of the Division's letters, funds generally would provide performance information concerning only those accounts that have "substantially similar investment objectives, policies, and strategies," although "an adviser may choose to exclude certain similar accounts . . . so long as such exclusion would not cause the composite performance to be misleading." A predecessor account would have to be managed in a manner that is "in all material respects equivalent" to the advertised mutual fund in order for predecessor performance to be presented.

These general standards are intended to discourage fund sponsors from “cherry-picking” the related accounts and from drawing comparisons to related accounts that are not managed in a sufficiently similar manner to the advertised fund. Nevertheless, the determination of whether a related account should be included in Related Performance Information and whether it is sufficiently similar to the advertised fund is a highly subjective one. Even with these general standards — and without any intention to defraud or mislead investors — mutual fund sponsors might present Related Performance Information that places undue weight on better-performing accounts or that is based on related accounts that are not managed in a sufficiently similar manner to the advertised fund. It may be difficult for those preparing the sales material to “screen out” their internal biases when they select the related accounts to include in the performance data. Yet this temptation to compare the advertised fund to superior-performing related accounts might so undermine the integrity of the Related Performance Information that its presentation could mislead investors.

Some have expressed similar concerns about manager performance information. The value of this information would partially depend upon the extent to which the portfolio manager was solely responsible for the performance of the predecessor fund and will be solely responsible for the performance of the advertised fund. In *Bramwell*, the portfolio manager was responsible for the day-to-day operations of both her former and current funds. The Division presumably would not have reached a similar conclusion had multiple portfolio managers managed either portfolio.

Many mutual fund management companies employ or retain research

analysts who recommend investment actions to the portfolio manager; traders who attempt to obtain best price and execution, which may be partially based on the volume of the fund’s transactions; and other staff who assist the portfolio manager’s investment selection and who help make the mutual fund’s operations more efficient, thereby reducing the fund’s expense ratio and enhancing its performance. NASD Regulation requests comment on whether, under these circumstances, members should be permitted to present manager performance in mutual fund sales material. Would the presentation of manager performance necessarily mislead investors into believing that this performance was attributable solely to the efforts of the portfolio manager, even when it was largely attributable to the personnel and resources of the fund’s investment adviser?

If Related Performance Information were permitted, NASD Regulation requests comment on what, if any, conditions could be placed on its presentation to ensure that the information is calculated in a sufficiently objective manner and the related accounts selected by the fund sponsor (including any predecessor fund) are sufficiently similar to the advertised mutual fund. Would some private accounts (e.g., collective investment funds) serve as a better basis for comparison than other private accounts (e.g., individual retail accounts)? Should NASD Regulation insist that the mutual fund and the related account share not only investment advisers but all subadvisers? NASD Regulation understands that the Association for Investment Management and Research has promulgated guidelines for the presentation of composite private account performance information. These guidelines govern such matters as the selection of private accounts to include in composite data, the criteria

used to maintain the composite, the calculation of the composite performance data, and the verification of this data by an independent third party. Should NASD Regulation permit the presentation only of composite private account information that complies with applicable AIMR standards and that has been verified by a qualified, independent third party? What standards, if any, should NASD Regulation apply to ensure that the verifying party is truly independent and qualified?

Should NASD Regulation make explicit what *Bramwell* seems to imply, that the presentation of manager performance information must, at a minimum, be contingent upon disclosure in the prospectus for the previous fund that the portfolio manager was the person responsible for day-to-day management of that fund? Should NASD Regulation explicitly prohibit the use of manager information if the previous prospectus disclosed that the decisions of the named portfolio manager were ratified by a committee? Should NASD Regulation prohibit use of manager performance information when the manager managed only a segment of a portfolio (e.g., the equity portion of a balanced portfolio)? How should differences in research and trading support be reflected?

3) Should NASD Regulation Impose Standards to Discourage the “Incubation” of Private Account Performance?

Some commentators have expressed concern about the possibility that investment advisers might create private “incubator” funds in order to establish various performance records and convert the private fund that attains the best performance. In response to an inquiry on this subject, the Division recently issued a letter in which it expressed “severe reservation” about incubator funds.

The Division noted that a converted mutual fund is likely to be managed differently than it was during the period of its incubation, and that it could be misleading for a fund sponsor to select the performance of a single incubator fund without disclosing the performance of less successful but similarly managed funds. The Division stated that disclosure about the sponsor's purpose in establishing the incubator fund would have to be "extremely clear." The Division contrasted the incubator fund situation with the circumstances in *MassMutual*.³

To what extent does "incubation" present an investor protection concern, assuming that the predecessor fund was managed in a sufficiently similar manner to the successor fund? What, if any, criteria should NASD Regulation impose in its filings review program in order to discourage the creation of incubator funds? For example, should NASD Regulation prohibit the use of predecessor performance once the converted mutual fund has been in existence for as long as the predecessor account had been? Such a condition might discourage the creation of incubator funds to establish a short-term performance record. Should a mutual fund that had been converted from a predecessor account be required to disclose the fact that the adviser managed other private accounts that were less successful? (NASD Regulation does not currently require mutual fund sales material to disclose the performance of the investment adviser's other mutual funds.) Should this problem be addressed by limiting Related Performance Information to the use of composites under AIMR standards which, among other things, appear to prohibit elimination of closed or terminated accounts from the corporate results for the period in which they were managed?

4) Should NASD Regulation Impose Standards to Promote the Comparability of Performance Data?

NASD Regulation requests comment on what, if any, conditions imposed in its filings review program could help investors compare and understand different types of performance data. For example, if NASD Regulation were to permit use of manager performance information, then sales material could present the performance record of the fund being advertised and the fund that the portfolio manager previously managed. The presence of both performance quotations could complicate an investor's ability to compare the information in that sales material with performance information in another sales piece. In addition, a portfolio manager might have left two fund groups, in which case the sales material could describe three separate funds. Moreover, NASD Regulation requests comment on whether the manager's previous fund should be permitted to present its performance history, if it is simultaneously presented as manager performance information by the manager's new fund.

A similar issue might arise when an investor attempts to compare sales material with various types of Related Performance Information, such as an advertisement containing manager performance to one containing clone performance, to one containing predecessor performance. In these cases, the presence of different performance quotations covering various time periods and calculated in different ways could complicate the ability of investors to compare mutual fund performance and thus undermine an important advantage that the SEC's standardization of mutual fund performance has achieved.

Another aspect of Related Perfor-

mance Information that may complicate an investor's ability to compare performance data is the apparent absence of uniform standards concerning the calculation of the *components* of this information, such as those concerning the manner in which portfolio securities are priced, the frequency with which they are valued, or the accounting of income and expenses by the portfolio. Would different accounting methods make an accurate comparison of performance data more difficult? What, if any, criteria could NASD Regulation impose in the filings review process to address this concern? For example, data that is based on different accounting methods might tend to converge when they pertain to longer periods. Should NASD Regulation require that nonstandardized performance data pertain to a stated period of sufficient duration to better ensure that the data produced by different accounting methods will tend to converge? Would the imposition of the AIMR standards for the calculation of nonstandardized private performance data address these concerns?

Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley
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Comments must be received by **September 29, 1997**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the

NASD Regulation, Inc. Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

Endnotes

¹ A Division “no-action letter” represents a statement by the Division that it would not recommend that the SEC take enforcement action under the federal securities laws if a person engages in certain specified activity.

² Since the Division’s issuance of its *Mass-Mutual* no-action letter (described below), NASD Regulation has permitted members, under appropriate conditions, to describe pre-

decessor performance (concerning insurance company separate accounts, private investment companies or common trust funds) in their sales materials. NASD Regulation is reviewing its position concerning the presentation of predecessor performance as part of its comprehensive consideration of the presentation of all types of Related Performance Information.

The NASD has issued guidelines in IM-2210-2 that govern the presentation by an existing fund of how it would have performed had it been an investment option within a variable product. IM-2210-2 states that a member communication may contain the fund’s historical performance predating its

inclusion in the variable product, provided that no significant changes occurred to the fund when it became part of the variable product or thereafter. The communication may not include the performance of an existing fund to promote a variable product that provides, as an investment option, a clone or model of the existing fund.

³ See Letter from Jack W. Murphy, Associate Director (Chief Counsel), Division of Investment Management, to Dr. William Greene (February 3, 1997).

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