NASD Notice to Members 96-84

NASD Regulation Solicits Comment On The Use Of Bond Mutual Fund Risk Ratings In Supplemental Sales Literature; **Comment Period Expires February 24, 1997**

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In the following document, NASD Regulation, Inc. (NASD Regulation) requests comment on the use by NASD® members (securities broker/dealer firms) and their associated persons of bond mutual fund risk ratings in sales literature given to customers. In particular, NASD Regulation is seeking comment on whether it should continue to prohibit the use of bond mutual fund risk ratings by members and their associated persons. In addressing this issue, commenters are asked to consider whether, with certain required disclosures or other adjustments, such ratings would in fact provide useful information to investors. NASD Regulation requests that NASD members, investors, and others, in considering their responses and comments, focus in particular on the need on the one hand to provide investors with as much useful information as possible to make informed investment decisions, and the concern on the other hand that certain information, depending on its availability or how it is produced or presented, may have the potential of being misleading or deceptive or otherwise lend itself to abuse.

Questions concerning this Request for Comment may be directed to R. Clark Hooper, Senior Vice President, Office of Disclosure and Investor Protection, NASD Regulation, at (202) 728-8325; and Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Solicitation Of Comments

NASD Regulation supports efforts to disclose the risks of investing in bond mutual funds in a way that is understandable and helpful to investors. At the same time, NASD Regulation needs to weigh the utility of any disclosure against the danger that it may be predictive, misleading, or otherwise inappropriate. NASD Regulation is requesting comment on whether, and to what extent, the use by members and associated persons of bond mutual find risk ratings in supplemental sales literature ought to be permitted under current NASD rules or new NASD rules.

Comments can be mailed to:

Joan Conley
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Comments should be received **by February 24, 1997**.

NASD Regulation Request For Comment 96-84

Executive Summary

NASD Regulation, Inc. (NASD Regulation) requests comment on the use by NASD® members (securities broker/dealer firms) and their associated persons of bond mutual fund risk ratings in sales literature given to customers. In particular, NASD Regulation is seeking comment on whether it should continue to prohibit the use of bond mutual fund risk ratings by members and their associated persons. In addressing this issue, commenters are asked to consider whether, with certain required disclosures or other adjustments, such ratings would in fact provide useful information to investors. NASD Regulation requests that NASD members, investors, and others, in considering their responses and comments, focus in particular on the need on the one hand to provide investors with as much useful information as possible to make informed investment decisions, and the concern on the other hand that certain information, depending on its availability or how it is produced or presented, may have the potential of being misleading or deceptive or otherwise lend itself to abuse.

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Background

Bond mutual fund risk ratings are produced by rating agencies and information vendors, none of which is an NASD member firm. The ratings generally represent opinions regarding a fund's "market risk," or a judgment of the probability that prices of bonds, and the bond funds that hold them, will react in a given way to changes in market conditions and the general economy, such as a sudden move up or down in interest rates. Such opinions may be based on an evaluation of a broad range of information, including, among other things, an evaluation of specific risks (such as interest rate risk, prepayment risk, currency risk), the credit quality of the fund's individual portfolio holdings, the market price volatility of the portfolio, the investment philosophy of the fund's management and its track record, and the historical reaction of the fund to various market conditions. There is no specified or uniform range of information used by all rating entities, and different kinds of ratings are produced using different criteria. Some rating entities represent their opinions by a word, symbol, or number that attempts to be a single, all-encompassing measure of fund risk.

Within the past two years the NASD has received several requests from bond fund rating entities to allow bond mutual fund risk ratings to be used in members' supplemental sales literature.[1] In the past, staff of NASD Regulation has taken the position that a rating that represents a judgment of how a bond fund will react to changes in various market conditions would be predictive of fund performance or misleading and, therefore, prohibited for use by members and associated persons in sales literature. This position has been endorsed by NASD Regulation's Investment Company Committee, which opposes a change from the current position. The staff's position was based on an interpretation of specific provisions in the NASD Conduct Rules regarding communications with the public.[2] The NASD Regulation Board of Directors has not yet adopted a position regarding this issue. More recently, the staff has considered whether such ratings could be used if they were accompanied by disclosure designed to limit the potential that the information could be misunderstood and if the symbols used for such ratings were altered to clarify their meaning or eliminate confusion with similar symbols used for credit ratings.

Discussion

Concerns Regarding The Use Of Bond Mutual Fund Risk Ratings

Predictions And Projections Of Investment Results

One objection that has been made to the use of bond mutual fund risk ratings is that a rating that represents a judgment of the probability that a bond fund's net asset value will react in a given way to changes in interest rates or other market conditions would, by implication, tend to predict fund performance.

The fundamental objection to future fact claims of performance for an individual security is that such claims rest upon a large number of assumptions and speculations about general economic conditions in the future and an equally large number of forward-looking assumptions about the individual security, including company solvency, management style, business strategy, investment policy, portfolio changes, future dividend streams, and rates of return. Thus, according to this reasoning, performance predictions and projections based on such assumptions are seldom reliable, and would necessarily tend to be misleading.[3]

Selective Availability

The use of bond mutual fund risk ratings also raises issues relating to selective availability and use of the ratings. Bond fund risk information generally is provided only to those funds that pay for the service. If a fund disagrees with a rating or does not wish to make a rating known publicly, it may opt not to obtain or reveal the rating. Therefore, the universe of funds for which investors can obtain risk ratings is limited to the number of funds that have paid for a rating and have determined to make them publicly known. This differs, for example, from the practice of certain mutual fund ranking entities that provide mutual fund ranking information for all publicly issued mutual funds, regardless of whether the mutual fund pays for the ranking service. Such information is always publicly accessible by investors, regardless of whether the mutual fund disagrees with the rating or chooses not to advertise it. Thus, one issue raised is whether this selective availability of bond fund risk information would create an unfair built-in marketing bias in favor of funds that purchase a rating.

Methodologies And Symbols

Some bond mutual fund risk ratings are based on methodologies that are not fully described or explained in the risk rating material. Thus, it may be difficult to understand how the final assignment of a risk measurement to a particular bond fund is derived. In some instances, the final assignment of a rating is in the form of a single word, symbol, or number. The use of a word, symbol, or number that attempts to be a single, all-encompassing measure of fund risk, without a clear explanation of how the word, symbol, or number was derived, may provide little useful information to investors. Further, investors may tend to rely too heavily on such a single measurement of risk without careful regard to their own particular investment goals.

Moreover, some rating entities use symbols for risk that closely resemble, and could easily be confused with, symbols used for bond fund credit ratings. Finally, some rating entities provide relative or comparative ratings using a relatively small universe of all possible ratable bond funds, which may provide skewed or misleading information.

Sales Practices

Objections have been raised that bond mutual fund risk ratings may be misinterpreted or otherwise misused by securities salespersons who provide bond fund risk rating materials to prospective investors in their sales presentations. Brokers may focus an investor's attention inappropriately on a risk rating as the key factor in the decision-making process, or use a given rating to suggest that the fund is predicted to perform a certain way under certain market conditions.

Arguments In Favor Of The Use Of Bond Mutual Fund Risk Ratings

Predictions And Projections Of Investment Results

Investors need information to make informed and reasoned decisions about investments. A basic goal of the securities laws thus is full and fair disclosure of material information upon which investors can make informed judgments about how a security might perform.

The investment decision-making process is one in which investors seek to make educated guesses about future performance. Since the primary objection to risk ratings is the potential to confuse and to predict, with proper disclosure investors should be able to evaluate their usefulness. The Securities and Exchange Commission (SEC) encourages and sanctions forward-looking information in SEC filings. SEC Rule 175 under the Securities Act of 1933[4] and SEC Rule 3b-6 under the Securities Exchange Act of 1934[5] provide a limited "safe harbor" for projections made or reiterated in a document filed with the SEC or in a report to shareholders filed with the SEC by a public company or in a registration statement. The substantive provisions of the safe harbor relieve the company of liability under the antifraud provisions of the securities laws for the forward-looking statement or projection, provided the projection was made with a reasonable basis and in good faith.

In addition, under the Management Discussion and Analysis (MD&A) section of SEC Regulation S-K,[6] the SEC requires the management of a company to assess the past performance of the business and to provide its view of which operations, trends, and forces will affect future operations. The MD&A section imposes on management a duty to disclose trends that are likely to affect performance, liquidity, or capital resources as well as the effects of inflation on operations. Inevitably, such disclosures involve many subjective judgments and predictive information.

Recently, the Private Securities Litigation Reform Act of 1995 (Act) established a two-part statutory safe harbor that provides certain protection from liability from private lawsuits where certain forward-looking information is used. The safe harbor protects forward-looking statements when accompanied by meaningful cautionary statements identifying factors that could cause actual results to differ materially from those projected in the statement. The Act also protects a person or business entity from liability in a private lawsuit for a forward-looking statement unless the false or misleading forward-looking statement was made with actual knowledge that it was false or misleading. However, the safe harbor does not protect a forward-looking statement contained in a registration statement of a mutual fund.

Under SEC rules, a mutual fund is required to discuss in its prospectus the principal risk factors associated with investing in a fund, including those risks that apply generally to funds with similar investment policies and objectives.[7] Through a Concept Release issued in 1995, the SEC solicited comment on how to improve risk disclosure for investment companies, or include ways to disclose the comparative risks of funds.[8] Many commenters supported enhanced mutual fund risk disclosure of some kind. Nonetheless, some commenters opposed any requirement that funds calculate and disclose a single, standardized, numerical assessment of risk on the basis that a single measurement would not be accurate and would be relied upon too heavily by investors. In particular, the Investment Company Institute commented that it opposed such a single measurement and that risk disclosure could be improved by, among other things, including narrative risk disclosure that focuses on the overall risks of the fund.[9] Other commenters critical of current risk disclosure requirements and practices in fund literature stated that, because of portfolio turnover, the concept of risk cannot be calculated numerically and that any risk measurement may be static and obsolete once it reaches investors.

Historical data concerning the performance of any particular investment or its behavior under certain market conditions generally carry implications about future performance. That is why investors seek such information—so they can make educated guesses about future performance and behavior.

Finally, the predictive element of bond mutual fund risk ratings is not dissimilar to the predictive element that accompanies bond fund credit ratings currently permitted to be used by members in supplemental sales literature. Volatility ratings for collateralized mortgage obligations are also currently permitted under the advertising and sales literature rules, with proper disclosure.

Selective Availability

Selectivity or selective availability has never been, by itself, a bar to disclosure of information that otherwise comports with NASD rules governing communications with the public. Although some bond mutual fund risk ratings are selectively given on the basis of whether a fund pays for a rating and whether it chooses to reveal its rating, the use in supplemental sales literature of bond fund credit ratings that are also selectively available is currently permitted. The practice of selectivity, broadly speaking, is generally true of all advertising and sales literature. In deciding to promote one product over another, member firms selectively screen for a given attribute as a matter of course and, therefore, it is inescapable that selectivity will be involved when a firm advertises its performance. The use of mutual fund rankings, for example, is intended to emphasize the best performing fund in a given category or sub-category over selected time periods. In addition, using non-performance criteria, a particular member may wish to promote the fact that a certain fund group is a no-load group, allows switching between funds at no extra charge, or adheres to a certain investment philosophy.

Methodologies And Symbols

Institutional and individual investors are presented with voluminous and complicated information sources in making investment decisions. It is difficult for issuers, broker/dealers, various information vendors, and the financial press to present complicated financial information in a simplified way that is comprehensible without being inaccurate. Conveying complicated information accurately through advertising and sales literature is particularly difficult. NASD advertising and sales literature rules require, among other things, that all communications with the public provide a sound basis for evaluating the facts in regard to a particular security or type of security or service offered. All supplemental sales literature is reviewed by the NASD Regulation[SM] staff for compliance with NASD rules within 10 days of first use, and NASD Regulation may require any changes to the content of such information or the manner in which it is presented as may be necessary to bring it into compliance with NASD rules.

Sales Practices

If the primary objection to the use of bond mutual fund risk ratings is that the ratings may be misinterpreted or otherwise misused by securities salespersons, it may be more appropriate for NASD Regulation to adopt any rules or interpretations to its sales supervision rules that are necessary to prevent such abusive sales practices or to address this issue through the examination process rather than prohibit the dissemination of the ratings information.

Solicitation Of Comments

NASD Regulation supports efforts to disclose the risks of investing in bond mutual funds in a way that is understandable and helpful to investors. At the same time, NASD Regulation needs to weigh the utility of any disclosure against the danger that it may be predictive, misleading, or otherwise inappropriate. NASD Regulation is requesting comment on whether, and to what extent, the use by members and associated persons of bond mutual find risk ratings in supplemental sales literature ought to be permitted under current NASD rules or new NASD rules. NASD Regulation asks members and other interested persons in commenting to consider the following specific questions and to provide any general comments they feel are appropriate.

1. In general, are bond mutual fund risk ratings represented by a single word, symbol, or number that attempts to be an all-encompassing measure of fund risk useful to investors?

2. Do bond mutual fund risk ratings, as described in this Request for Comment, constitute a projection or prediction of investment results in a way that could be considered misleading to an investor, or should risk ratings be viewed as forward-looking information that would be appropriate to provide to an investor? What additional disclosures, if any, would be appropriate to mitigate the concern that risk ratings could be considered predictive?

3. Should selectivity or selective availability for bond mutual fund risk ratings, as described in this Request for Comment, have any bearing on whether it is appropriate to provide bond mutual fund risk ratings to investors? Does the fact that ratings may only be provided to funds who pay for the rating and choose to make the rating available undermine the usefulness of the information? Is it appropriate or accurate for rating entities that provide ratings on a comparative basis to provide such ratings for a relatively small sample of the entire universe of bond funds that could be rated?

4. If disclosure of bond mutual fund risk ratings is permitted, how important is it for an investor also to understand the process (methodologies and calculations) by which the rating is derived? Will investors tend to rely too heavily on an opinion of bond mutual fund risk represented by a word, symbol, or number that attempts to be a single, all-encompassing measure of fund risk? Can the potential for confusion be mitigated by disclosure?

5. Do current NASD rules for communications with the public provide a sufficient regulatory framework within which the characteristics and dangers of bond mutual fund risk ratings can be addressed? Would it be more appropriate to amend or revise the current NASD rules? Or, instead, would it be more appropriate to develop additional rules or guidelines for bond mutual fund risk ratings?

6. A decision to allow the use of bond mutual fund risk ratings would permit ratings from different rating entities using distinct analytical methods and approaches. What level and type of scrutiny should NASD Regulation staff provide in reviewing the use of ratings?

7. As mentioned above, bond mutual fund **credit** ratings are currently permitted to be used by members in supplemental sales literature, and volatility ratings for collateralized mortgage obligations are also currently permitted under the advertising and sales literature rules, with proper disclosure. Is there a reasonable basis for distinguishing between the use of bond fund credit ratings and collateralized mortgage obligation volatility ratings on the one hand and bond mutual fund risk ratings on the other hand?

8. Is it more appropriate to address the concerns related to inappropriate use of bond mutual fund risk ratings through heightened sales supervisory practices rather than disclosure or an

outright prohibition? If so, what sort of additional supervisory practices would you recommend be implemented?

Comments can be mailed to:

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pubcom@nasd.com.

Comments should be received **by February 24, 1997**.

Endnotes

[1] "Supplemental sales literature" is not defined in federal securities statutes or the NASD rules. It is used in the investment company industry to refer 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 prospectus.

[2] The NASD rules authorize the staff to prohibit the use by members and associated persons of information that predicts or projects future performance. Subparagraph (d)(1)(A) to NASD Conduct Rule 2210 states that "[a]ll member communications with the public should provide a sound basis for evaluating the facts in regard to any particular security....No material fact or qualification may be omitted if the omission...would cause the advertising or sales literature to be misleading." Subparagraph (d)(1)(B) to Rule 2210 states in addition that "[e]xaggerated, unwarranted or misleading statements or claims are prohibited in all public communications of members." Moreover, subparagraph (d)(2)(N) to Rule 2210 provides that "[i]nvestment results cannot be predicted or projected."

[3] See, Note 2, above.

[4] See, Rule 175 under the Securities Act of 1933, Liability For Certain Statements by Issuers, 17 CFR 230.175.

[5] See, Rule 3b-6 under the Securities Exchange Act of 1934, Liability for Certain Statements by Issuers, 17 CFR 240.3b-6.

[6] See, Item 303 of Regulation S-K, Management's Discussion and Analysis of Financial Condition and Results of Operations, 17 CFR 229.303.

[7] See, Item 4(c), Form N-1A, and Guide 21, Disclosure of Risk Factors, Guidelines for Form N-1A, 17 CFR 239.15A, and 274.11A.

[8] See, Investment Company Act Rel. No. 20974 (March 29, 1995); 60 FR 17172 (April 4, 1995).

[9] See, letter from Paul Schott Stevens, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC, dated July 28, 1995.