

# Notice to Members

JANUARY 2006

## SUGGESTED ROUTING

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

## KEY TOPICS

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

## GUIDANCE

### Bond Mutual Fund Volatility Ratings

SEC Approves Permanent Rules Concerning Bond Mutual Fund Volatility Ratings; **Effective Date: December 27, 2005**

#### Executive Summary

On December 27, 2005, the Securities and Exchange Commission (SEC) approved a proposed rule change to make permanent Rule 2210(c)(3) and Interpretive Material 2210-5 (collectively, the "Rule") concerning bond mutual fund volatility ratings.<sup>1</sup> The Rule previously had operated as a pilot program. Interpretive Material 2210-5 permits members and associated persons to include bond mutual fund volatility ratings in supplemental sales literature, subject to certain conditions. 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.

The Rule became immediately effective on the date of SEC approval. Included with this *Notice* is Attachment A (text of rule as amended).

#### Questions/Further Information

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

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## Discussion

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.<sup>2</sup> 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, 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).

The SEC originally approved the Rule on an 18-month pilot 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. NASD also sought to consider whether additional guidance concerning the use of certain terminology was necessary, whether the Rule should apply to in-house ratings, whether the Rule should apply to all investment companies, and whether additional standards or guidance was needed to prevent investor confusion or minimize excessive variability among ratings of similar portfolios.

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Due to the small number of bond fund volatility ratings filings received during the Rule's initial 18-month pilot, NASD extended the pilot to accumulate more data with which to evaluate the program. Ultimately, during the entire period from February 2000, when the Rule was first approved, until the present, NASD has received a total of 47 submissions from seven NASD members. In general, the filings of sales material that contained bond fund volatility ratings have met the Rule's requirements.

Based on its findings during this period, NASD concluded that the Rule's provisions are appropriate and should be made permanent without further amendment. NASD believes that the Rule has facilitated the dissemination of useful and understandable information to investors and has prevented the dissemination of inappropriate or misleading information.

NASD also considered whether the timeliness requirements of IM-2210-5 (which requires sales literature to reflect information that, at a minimum, is current to the most recently completed calendar quarter end) continue to be appropriate. In this regard, since the Rule's adoption, SEC Rule 482 has been amended generally to require advertised mutual fund performance to be current as of the most recent month-end, or alternatively, to disclose where the reader may obtain the most recent month-end performance.<sup>3</sup> NASD determined that it is unnecessary to modify the timeliness requirements of IM-2210-5(b)(2) to mirror those of amended Rule 482, since NASD understands that it is quite rare for ratings agencies to revise a volatility rating on a month-to-month basis. Nevertheless, a member may not distribute supplemental sales literature containing a bond fund volatility rating if the member knows or has reason to know that the rating is false or misleading, even if the rating was current as of the most recent calendar quarter end.<sup>4</sup>

See Attachment A for the full text of IM 2210-5 as amended.

## Effective Date

The Rule became permanently effective on December 27, 2005, the date the SEC approved the proposed rule change.

## Endnotes

- 1 See Securities Exchange Act Release No. 53027 (Dec. 27, 2005); 71 FR 375 (Jan. 4, 2006) (SR-NASD-2005-117).
- 2 See Securities Exchange Act Release No. 42476 (Feb. 29, 2000); 65 FR 12305 (March 8, 2000) (SR-NASD-97-89).
- 3 See SEC Rule 482(g) under the Securities Act of 1933, 17 C.F.R. 230.482(g) .
- 4 See NASD Rule 2210(d)(1)(B).

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## **ATTACHMENT A – RULE TEXT**

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

#### **(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.

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**(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.