

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-48353; File No. SR-NASD-2003-126)

August 15, 2003

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. to Extend the Pilot Period for Rules Relating to Bond Fund Volatility Ratings

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on August 7, 2003, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the NASD. The NASD filed the proposal pursuant to Section 19(b)(3)(A) of the Act,³ and Rule 19b-4(f)(6) thereunder,⁴ which renders the proposal effective upon filing with the Commission.⁵ The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The NASD proposes to extend the expiration date of the pilot period for the NASD's rules concerning bond mutual fund volatility ratings. The current pilot is scheduled to expire on

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).

⁵ The NASD provided written notice of its intention to file the proposed rule change on August 5, 2003. The Commission reviewed the NASD's submission, and told the NASD it was acceptable to file the proposed rule change immediately. The NASD asked the Commission to waive the 30-day operative delay. See Rule 19b-4(f)(6)(iii). 17 CFR 240.19b-4(f)(6)(iii).

August 31, 2003. The proposed rule change extends the pilot period until August 31, 2005. The text of the proposed rule change is below. Proposed new language is in italics; proposed deletions are in brackets.

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) through (c) No change.

* * * * *

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NASD has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Background and Description of the NASD's Rules on Bond Mutual Fund Volatility Ratings

On February 29, 2000, the Commission 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).⁶ The Commission 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, the 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 Advertising Regulation Department of the NASD ("Department") at least 10 days prior to use for Department approval. If the Department requests

⁶ See Securities Exchange Act Release No. 42476 (February 29, 2000), 65 FR 12305 (March 8, 2000)(SR-NASD-97-89).

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 refiled and approved.

IM-2210-5 and the new Rule 2210(c)(3) initially were approved on an 18-month trial basis that was scheduled to expire on August 31, 2001.⁷ On August 10, 2001, the NASD filed with the Commission a proposed rule change that was effective upon filing that extended the effectiveness of IM-2210-5 and Rule 2210(c)(3) an additional two years until August 31, 2003.⁸

Proposed Rule Change to Extend the Expiration Date of IM-2210-5 and Rule 2210(c)(3)

As indicated in the Commission's order approving IM-2210-5 and Rule 2210(c)(3), the NASD requested the 18-month trial period to provide 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.⁹ During the initial 18-month pilot period, the Department received very few filings that contained bond fund volatility ratings. Although these filings generally met the rule's requirements, the staff did not believe that it had received a sufficient number of filings to adequately evaluate the rule's effectiveness. Accordingly, in July 2001, the NASD Regulation, Inc. Board of Directors authorized a rule filing with the Commission to extend the pilot for two years. The NASD subsequently filed with the Commission a proposed rule change, which was effective upon filing, to extend the pilot period until August 31, 2003.¹⁰

⁷ Id.

⁸ See Securities Exchange Act Release No. 44737 (August 22, 2001), 66 FR 45350 (August 28, 2001)(SR-NASD-2001-49).

⁹ See footnote 6, supra.

¹⁰ See footnote 8, supra.

Since August 2001, the Department has continued to receive very few filings under this rule. During the entire period from February 2000, when the rule was first approved, until the present, the 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 does not believe that it has received a sufficient number of filings to adequately evaluate the rule's effectiveness.

In particular, the NASD believes that, because of the low interest rates over the last two years, bond mutual funds have had little reason to distribute sales material that contains volatility ratings. The NASD believes that it needs to review the rule in an environment in which there is greater demand for sales literature that includes bond mutual fund volatility ratings to determine the rule's effectiveness. The NASD believes there is a reasonable probability that such environment will exist over the next two years.

Accordingly, the NASD proposes 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. Before this period expires, the staff will evaluate the rule and determine whether to recommend that the rule be eliminated, modified, or permanently approved as is. The proposal contains no substantive changes to the way in which the pilot has operated during the past two years; it only extends the pilot period by an additional two years.

2. Statutory Basis

The NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹¹ which requires, among other things, that the NASD's rules be designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and, in general, protect investors and the public interest. The NASD believes

¹¹ 15 U.S.C. 78o-3(b)(6).

that extending the expiration date of IM-2210-5 and Rule 2210(c)(3) will provide the additional experience necessary to fully analyze and evaluate the provisions.

B. Self-Regulatory Organization's Statement on Burden on Competition

The NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing proposed rule change does not:

(i) significantly affect the protection of investors or the public interest;

(ii) impose any significant burden on competition; and

(iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act¹² and Rule 19b-4(f)(6) thereunder.¹³ At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

The NASD has asked the Commission to waive the 30-day operative delay. The Commission believes waiving the 30-day operative delay is consistent with the protection of investors and the public interest. Such waiver will allow the pilot to operate without interruption

¹² 15 U.S.C. 78s(b)(3)(A).

¹³ 17 CFR 240.19b-4(f)(6).

through August 31, 2005. For these reasons, the Commission designates the proposal to be effective and operative upon filing with the Commission.¹⁴

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file

¹⁴ For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

number SR-NASD-2003-126 and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁵

Margaret H. McFarland
Deputy Secretary

¹⁵ 17 CFR 200.30-3(a)(12).