

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-53027; File No. SR-NASD-2005-117)

December 27, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto Seeking Permanent Approval of Rules Concerning Bond Mutual Fund Volatility Ratings Prior to Expiration of Pilot

I. Introduction

On September 28, 2005 and October 24, 2005 (Amendment No. 1),<sup>1</sup> the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>2</sup> and Rule 19b-4 thereunder,<sup>3</sup> a proposed rule change seeking permanent approval of NASD Rule 2210(c)(3) and Interpretive Material 2210-5 (collectively, the “Rule”) concerning bond mutual fund volatility ratings prior to the expiration of the pilot on December 29, 2005. The Commission published the proposed rule change for comment in the Federal Register on November 7, 2005.<sup>4</sup> The Commission received one comment letter on the proposal.<sup>5</sup> On December 16, 2005, NASD filed a response to the comment letter.<sup>6</sup> This order approves the proposed rule change, as amended.

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<sup>1</sup> Amendment No. 1 clarified the date of expiration of the pilot program concerning bond mutual fund volatility ratings.

<sup>2</sup> 15 U.S.C. 78s(b)(1).

<sup>3</sup> 17 CFR 240.19b-4.

<sup>4</sup> See Securities Exchange Act Release No. 52709 (November 1, 2005), 70 FR 67509 (November 7, 2005) (the “Notice”).

<sup>5</sup> See letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute (“ICI”) to Jonathan G. Katz, Secretary, SEC, dated November 28, 2005 (the “ICI Letter”).

<sup>6</sup> See letter from Joseph P. Savage, Associate Vice President, Investment Companies Regulation, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated December 16, 2005 (the “NASD Response”).

## II. Description of the Proposed Rule Change

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

On February 29, 2000, the SEC approved on a pilot basis 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).<sup>7</sup> At that time, the SEC also approved as a pilot 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 to investors through a toll-free telephone number or web site (or both) a detailed disclosure on its rating methodology.

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<sup>7</sup> See Securities Exchange Act Release No. 42476 (February 29, 2000); 65 FR 12305 (March 8, 2000) (SR-NASD-97-89).

- 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 for approval with NASD's Advertising Regulation Department ("Department"), at least 10 days prior to use, bond mutual fund sales literature that includes or incorporates volatility ratings. 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.

IM-2210-5 and Rule 2210(c)(3) initially were approved on an 18-month pilot basis that was scheduled to expire on August 31, 2001.<sup>8</sup> NASD subsequently renewed the pilot several times, most recently with a proposed rule change that was effective upon filing and extended the pilot provisions until December 29, 2005.<sup>9</sup>

#### Proposed Rule Change to Make Permanent IM-2110-5 and Rule 2210(c)(3)

As indicated in the SEC's original order approving IM-2210-5 and Rule 2210(c)(3) on a pilot basis and the NASD Notice to Members announcing such approval,<sup>10</sup> NASD requested the 18-month pilot period to consider whether:

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<sup>8</sup> Id.

<sup>9</sup> See Securities Exchange Act Release No. 52372 (Aug. 31, 2005); 70 FR 53405 (Sept. 8, 2005) (SR-NASD-2005-104); Securities Exchange Act Release No. 48353 (Aug. 15, 2003); 68 FR 50568 (Aug. 21, 2003) (SR-NASD-2003-126); NASD Notice to Members 03-48 (Aug. 2003); Securities Exchange Act Release No. 44737 (August 22, 2001); 66 FR 45350 (August 28, 2001) (SR-NASD-2001-49); NASD Notice to Members 01-58 (Sept. 2001).

<sup>10</sup> See Securities Exchange Act Release No. 42476 (February 29, 2000); 65 FR 12305 (March 8, 2000) (SR-NASD-97-89); NASD Notice to Members 00-23 (April 2000).

- The Rule has facilitated the dissemination of useful, understandable information to investors;
- The Rule has prevented the dissemination of inappropriate or misleading information by members and associated persons;
- Additional guidance concerning the use of certain terminology may be necessary;
- The Rule should apply to in-house ratings;
- The Rule should apply to all investment companies; and
- Additional standards or guidance is needed to prevent investor confusion or minimize excessive variability among ratings of similar portfolios.

Due to the small number of bond 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 September 2005 (when NASD initially filed this proposed rule change with the Commission), NASD 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 has concluded that the Rule's provisions are appropriate and do not require further amendment before being made permanent. In particular, 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. In this regard, virtually all of the filings NASD has received under the Rule have met the Rule's requirements, and NASD is not aware of any investor complaints concerning sales material that contains

volatility ratings. The level of member compliance with the Rule also suggests that members do not require additional guidance concerning the use of certain terminology in the Rule. Similarly, NASD is not aware of any concerns that investors may be confused or that there may be excessive variability among ratings or similar portfolios.

NASD also has examined the issue of whether the Rule should apply to in-house ratings. At the time the Rule was approved, NASD observed that the Rule should not apply to in-house ratings on the grounds that they are not procured for a fee, are used primarily by fund investors as an aid in distinguishing between risk levels within a family of funds, and may be calculated using different methods from those used in calculating volatility ratings.<sup>11</sup> NASD continues to believe that those are persuasive reasons to not apply the Rule to in-house ratings. NASD believes that in-house ratings do not raise the same concerns as third-party ratings, and thus do not merit application of the bond fund volatility ratings rule.

NASD also believes that it is unnecessary at this time to apply the Rule to other types of investment companies, such as unit investment trusts. At no time throughout the extended pilot period has a member requested that the Rule apply to such material, and NASD is not aware of third-party volatility ratings that are being used to assess other types of investment companies. Accordingly, NASD sees no need to expand the Rule's scope in this manner.

NASD believes that the Rule strikes an appropriate balance between the desire of some funds to advertise volatility ratings and the need to include appropriate disclosures

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<sup>11</sup> See Securities Exchange Act Release No. 42476 (February 29, 2000); 65 FR 12305 (March 8, 2000) (SR-NASD-97-89).

related to those ratings in sales material. Accordingly, NASD believes that the Commission should approve the Rule, as is, on a permanent basis.

IM-2210-5(b)(2) requires supplemental sales literature that includes bond fund volatility ratings to present the most recently available rating that “reflects information that, at a minimum, is current to the most recently completed calendar quarter ended prior to use.” At the time IM-2210-5 was adopted, this standard mirrored the timeliness standard for mutual fund performance advertising under Rule 482 under the Securities Act of 1933. However, in 2003, the SEC amended Rule 482 to require mutual fund performance advertising to show performance that is current to the most recent calendar quarter ended prior to submission of an advertisement for publication, and to indicate where the reader may obtain performance that is current to the most recent month ended seven business days prior to use through a toll-free (or collect) telephone number or web site, or to present performance that meets this most recent month-end standard.<sup>12</sup>

NASD understands that rating agencies typically monitor bond funds on a monthly basis, but that it is quite rare for such agencies to revise a volatility rating on a month-to-month basis. Accordingly, NASD does not believe that it is necessary to require that volatility ratings be current as of the most recent month end given that, among other things, unlike fund performance, such ratings do not frequently change once they are issued.

### III. Summary of Comments Received and NASD Response

The Commission received one comment letter from ICI on the proposal and a response to the comment letter by NASD.

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<sup>12</sup> Rule 482(g) under the Securities Act of 1933.

The ICI Letter generally expressed reservations about the use of bond mutual fund volatility ratings in supplemental sales literature.<sup>13</sup> The ICI Letter also suggested that if the pilot program was approved on a permanent basis that: (i) all of the critical investor protections of the original pilot program should remain intact, (ii) the use of a single symbol, number or letter to describe a volatility rating should be prohibited and (iii) the timeliness requirements of IM-2210-5(b)(2) should be modified to mirror the requirements of Rule 482 under the Securities Act of 1933.<sup>14</sup>

In response to ICI's general reservations regarding the use of bond mutual fund volatility ratings the NASD Response stated that "during the five and one-half years that the [bond mutual fund volatility rules] have been in effect, NASD has found no evidence that the use of volatility ratings in fund sales literature has harmed investors."<sup>15</sup> NASD also noted that it "has not proposed to eliminate any of the disclosure, filing or other investor protection requirements that were contained in the original pilot rule."<sup>16</sup>

In addition, NASD expressed doubt that use of a single symbol, number or letter to describe volatility ratings harms investors, stating "NASD fails to see how allowing the use of symbols, numbers and letters to describe a fund's volatility rating is any more harmful to investors than allowing symbols, numbers and letters to describe a fund's performance or performance ranking."<sup>17</sup>

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<sup>13</sup> ICI Letter, supra note 5, at 1.

<sup>14</sup> Id. at 1-2.

<sup>15</sup> NASD Response, supra note 6, at 2.

<sup>16</sup> Id.

<sup>17</sup> Id. at 3.

Furthermore, NASD disagreed with ICI's recommendation to modify the timeliness requirements of IM-2210-5(b)(2).<sup>18</sup> NASD indicated that "it is quite rare for [fund rating] agencies to revise a volatility rating on a month-to-month basis." Accordingly, NASD expressed its belief that it is not necessary "to require that volatility ratings be current as of the most recent month end given that such ratings rarely change once they are issued."<sup>19</sup> NASD, however, cautioned its members that 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>20</sup>

#### IV. Discussion and Findings

After careful review, the Commission finds that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, NASD rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The Commission believes that making IM-2210-5 and Rule 2210(c)(3) effective on a permanent basis will protect investors and the public interest by permitting NASD members to provide investors with useful information in a manner designed to prevent dissemination of inappropriate or misleading information.

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<sup>18</sup> Id.

<sup>19</sup> Id.

<sup>20</sup> Id. See also NASD Rule 2210(d)(1)(B).

V. Conclusions

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>21</sup> that the proposed rule change, as amended (SR- NASD-2005-117), be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>22</sup>

Nancy M. Morris  
Secretary

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<sup>21</sup> 15 U.S.C. 78s(b)(2).

<sup>22</sup> 17 CFR 200.30-3(a)(12).