December 16, 2005

Ms. Katherine A. England
Assistant Director
Division of Market Regulation
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-2001

Re: File No. SR-NASD-2005-117 – Proposed Rule Change Seeking Permanent Approval of Rules Concerning Bond Mutual Fund Volatility Ratings Prior to Expiration of Pilot: Response to Comments

Dear Ms. England:

NASD staff has reviewed the comment letter received by the Securities and Exchange Commission ("SEC") in response to SR-NASD-2005-117.[1] The response to the comment letter is provided below.

The proposed rule change seeks to make permanent NASD Rule 2210(c)(3) and Interpretive Material 2210-5 (together, the "Rules"), which permit members and their associated persons to use bond mutual fund volatility ratings in supplemental sales literature (mutual fund sales material that is accompanied or preceded by a fund prospectus), provided that such sales literature is filed in advance with and approved by the NASD Advertising Regulation Department. The SEC originally approved the Rules in February 2000 on a pilot basis that was set to expire on August 31, 2001;[2] the SEC subsequently approved extensions of the pilot rule, which is now set to expire on December 29, 2005.[3] The SEC published the proposed rule change and Amendment No. 1 for comment in the Federal

1 SEC Rel. No. 34-52709 (Nov. 1, 2005), 70 Fed. Reg. 67509 (Nov. 7, 2005) (Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto Seeking Permanent Approval of Rules Concerning Bond Mutual Fund Volatility Ratings Prior to Expiration of Pilot).

2 SEC Rel. No. 34-42476 (Feb. 29, 2000), 65 Fed. Reg. 12305 (Mar. 8, 2000) (SR-NASD-97-89).

3 *See* SEC Rel. No. 34-52372 (Aug. 31, 2005), 70 Fed. Reg. 53405 (Sept. 8, 2005) (SR-NASD-2005-104).

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Register on November 7, 2005, and received one comment letter on the proposal from the Investment Company Institute ("ICI").[4]

The ICI restates its long-held opposition to the Rules on the ground that the use of volatility ratings in fund sales literature raises serious investor protection concerns, citing comment letters that the ICI previously filed with the SEC both on the initial pilot rule proposal and proposals to extend the pilot rules. Accordingly, the ICI opposes the permanent approval of the Rules and recommends that the NASD prohibit the use of bond fund volatility ratings altogether.

The ICI letter does not raise any new arguments or reasons for prohibiting the use of bond fund volatility ratings in fund sales literature beyond what it has raised in the past when the rule pilot was first proposed or proposed for extension. NASD previously considered these arguments when it first proposed the Rules on a pilot basis and determined that they did not merit prohibiting the use of volatility ratings in fund sales literature. Moreover, during the five and one-half years that the Rules have been in effect, NASD has found no evidence that the use of volatility ratings in fund sales literature has harmed investors, nor does the ICI cite any such evidence. Accordingly, NASD believes that the ICI's recommendation that NASD prohibit the use of volatility ratings in fund sales material is without merit.

Next, the ICI recommends that, should the SEC determine to approve the Rules on a permanent basis, all of the investor protections of the original pilot program remain intact, and that two additional changes be made to the current rules. First, the ICI recommends that the Rules prohibit the use of a single symbol, number or letter to describe a volatility rating. The ICI argues that permitting ratings to be designated by a single symbol, number or letter will increase the likelihood that an individual investor will not evaluate the risk of a bond fund based on his or her investment objectives and risk tolerance, and instead will look to the single symbol, number or letter to make his or her investment decision. Second, the ICI recommends that the Rules be modified to mirror the timeliness requirements of Rule 482 under the Securities Act of 1933 to ensure that investors do not receive stale ratings. Rule 482 generally requires fund performance advertisements either to show the fund's performance as of the most recent month end, or show performance as of the most recent quarter end and include disclosure as to where the reader may obtain the most recent month-end performance.

NASD has not proposed to eliminate any of the disclosure, filing or other investor protection requirements that were contained in the original pilot rule. Accordingly, NASD has already met the ICI's first supplemental recommendation.

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4 Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Nov. 28, 2005).

NASD does not find any merit to the ICI's recommendation to prohibit the use of a single symbol, number or letter to describe a volatility rating. As discussed above, NASD has found no evidence during the pilot period that permitting single symbols, numbers or letters to describe volatility ratings has harmed investors, nor does the ICI cite any such evidence. In addition, current SEC and NASD fund advertising rules already permit the use of symbols, numbers and letters in the context of fund performance or performance rankings used in fund advertising, which ICI members frequently cite quite prominently to attract investors. 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.

NASD also rejects the ICI's recommendation that fund sales literature containing volatility ratings be required either to show the rating current as of the most recent month end, or disclose where the reader may obtain the most recent month-end rating. As NASD discussed in its rule filing, NASD understands that, while fund rating agencies typically monitor bond funds on a monthly basis, 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 such ratings rarely change once they are issued. The ICI has not offered any evidence that this understanding is incorrect; accordingly, NASD sees no reason to change the Rules as recommended.[5]

NASD believes that the foregoing fully responds to material issues raised by commenters to the rule filing. If you wish to discuss this matter further, please feel free to contact me at (240) 386-4534.

Sincerely,

Joseph P. Savage

Joseph P. Savage
Associate Vice President
Investment Companies Regulation

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5 Of course, no member may distribute sales literature that the member knows or has reason to know is false or misleading. NASD Rule 2210(d)(1)(B). Accordingly, 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.

cc: Haime Workie, Division of Market Regulation