

such steps as may be necessary to comply with Rules 6e-2 and 6e-3(T), as amended, or Rule 6e-3, as adopted, to the extent applicable.

13. No less than annually, Seligman and the Participants shall submit to the Boards such reports, materials or data as such Boards may reasonably request so that the Boards may fully carry out obligations imposed upon them by the conditions contained in the application. Such reports, materials and data shall be submitted more frequently if deemed appropriate by the applicable Boards. The obligations of Seligman, the Participating Insurance Companies and Qualified Plans to provide these reports, materials and data to the Boards, shall be a contractual obligation of Seligman, all Participating Insurance Companies and Qualified Plans under the agreements governing their participation in the Insurance Products Funds.

14. In the event that a Qualified Plan should ever become an owner of 10% or more of the assets of an Insurance Products Fund, the Qualified Plan will execute a fund participation agreement with the Insurance Products Fund, including the conditions set forth herein to the extent applicable. A Qualified Plan shareholder will execute an application containing an acknowledgment of this condition at the time of its initial purchase of shares of the Insurance Products Fund.

## Conclusion

For the reasons summarized above, Applicants assert that the requested exemptions are appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the 1940 Act.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42476; File No. SR-NASD-97-89]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving the Proposed Rule Change on a Temporary Basis and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 3 and 4 to the Proposed Rule Change on a Temporary Basis Relating to Bond Mutual Fund Volatility Ratings

February 29, 2000.

#### I. Introduction

On October 5, 1998,<sup>1</sup> the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly-owned subsidiary, the NASD Regulation, Inc. ("NASD" or "Regulation" or "NASDR"), 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 to permit members and associated persons to include bond mutual fund volatility ratings in supplemental sales literature for an 18 month trial period.

A notice of the proposed rule change appeared in the **Federal Register** on November 5, 1998.<sup>4</sup> The Commission received fourteen comment letters concerning the proposed rule change.<sup>5</sup> On November 9, 1998, NASDR filed Amendment No. 2 to clarify a formatting change to NASD Conduct Rule 2210(c).<sup>6</sup> On March 26, 1999, the NASDR filed amendment No. 3, in which it responded to the comment letters and amended the definition of Bond Mutual Fund Volatility Rating to clarify which funds would be subject to the proposal.<sup>7</sup>

<sup>1</sup> On December 12, 1997, the NASD submitted its initial proposal, which could have limited the effectiveness of the disclosure statement and prevented sales literature from containing relevant explanatory information concerning bond mutual fund volatility ratings. After discussions between NASD and the Commission, the NASD filed Amendment No. 1 on October 5, 1998, which replaced and superseded the initial proposal.

<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 Rel. No. 40627 (November 2, 1998), 63 FR 60431.

<sup>5</sup> See *infra* note 14.

<sup>6</sup> Letter from John Ramsay, Vice President and Deputy General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated October 30, 1998.

<sup>7</sup> The amendment to subsection (a) removes the reference to "bond mutual fund" and inserts after "portfolio," the phrase: "of an open-end

On August 18, 1999, NASDR filed Amendment No. 4, which amended subsections (b)(1) and (b)(3) by removing language that several commenters found misleading and confusing.<sup>8</sup> This order approves the proposed rule change. Amendment Nos. 3 and 4 are also approved on an accelerated basis.

#### II. Background

Bond mutual fund volatility ratings are descriptions of the sensitivity of bond mutual fund portfolios to changing market conditions. Currently, NASDR interprets its rules to prohibit members and associated persons from using bond mutual fund volatility ratings in supplemental sales literature. NASD rules do not apply to the use and dissemination of bond mutual fund volatility ratings by non-NASD members, including rating agencies and information vendors that issue the ratings, and mutual fund groups that use the ratings for promotional and marketing purposes.

Specifically, NASD Rule 2210 prohibits the use by members and associated persons of information that is misleading, that contains exaggerated, unwarranted or misleading statements or claims, or that predicts or projects investment results.<sup>9</sup> The NASD currently prohibits the use of bond mutual fund volatility ratings because it believes that judgments of how a bond mutual fund may react to changes in various market conditions may be predictive of fund performance or misleading.

In Notice to Members 96-84 (December 1996), the NASD requested comment on the appropriateness of its current prohibition. A majority of the

management investment company that invests in debt securities." Letter from John Ramsay, Vice President and Deputy General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated March 25, 1999 ("Amendment No. 3").

<sup>8</sup> The amendment to subsection (b)(1) removes the prohibition against using "a single symbol, number or letter" to describe volatility. The amendment to subsection (b)(3) removes the second sentence that stated, in relevant part, that "[subjective factors] may be used solely for purposes of determining whether to issue the rating." See letter from John Ramsay, Vice President and Deputy General Counsel, NASD Regulation, to Richard C. Strasser, Assistant Director, Division of Market Regulation and Mercer E. Bullard, Assistant Chief Counsel, Division of Investment Management, Commission, dated August 18, 1999 ("Amendment N. 4"). See also letter from Alden S. Adkins, Senior Vice President and General Counsel NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation and Mercer E. Bullard, Assistant Chief Counsel, Division of Investment Management, Commission, dated November 2, 1999.

<sup>9</sup> NASD Manual, Conduct Rules, Rule 2210.

commenters supported making the ratings available, and all of the commenters representing investors groups supported the goal of making accurate information regarding risk and volatility characteristics of bond funds available to investors. As a result, NASDR proposed an interpretation to permit the use of bond fund volatility ratings subject to certain conditions and disclosure requirements.

### III. Description of the Proposed Rule Change, including Amendment Nos. 3 and 4

#### *Trial Period*

The proposed rule change would permit, for an 18 month trial period, the use of the mutual fund volatility ratings subject to certain limitations, and provided certain disclosures are made. The NASD believes that this trial period should be a reasonable amount of time for the Advertising/Regulation Department ("Department") to determine whether the rules have facilitated the dissemination of useful, understandable information to investors and have prevented the dissemination of inappropriate or misleading information by members and associated persons.

#### *Definition of Bond Mutual Fund Volatility Rating*

Section(a) of the proposed rule change defines the term "bond mutual fund volatility rating" to mean, in part, a description issued by an independent third party relating to the sensitivity of a bond mutual fund's net asset value to changes in market conditions and the general economy, based on an evaluation of objective factors regarding the fund's current characteristics and its past performance. The definition recognizes that the rating is an opinion of the fund's potential share price movement in response to various economic conditions or market situations, and not a prediction of the actual movement of a fund's share price. In Amendment No. 3, the NASDR also proposes to amend this definition to clarify that the rule applies only to open end investment companies.<sup>10</sup>

#### *Prohibitions*

Subsection (b) of the proposed rule change permits members and associated persons to use a bond mutual fund volatility rating only in supplemental sales literature and only when certain requirements are satisfied.

Subsection (b)(1) prohibits the use of a bond mutual fund volatility rating that uses the word "risk" to describe the

rating. This prohibition is intended to remove any confusion concerning the word "risk," which is capable of multiple meanings and interpretations. Thus, the NASDR believes that referring to these ratings as "volatility" rather than "risk" ratings is more precise. The proposal had also prohibited the use of a "a single symbol, number or letter" to describe the ratings. Amendment No. 4, however, removed this prohibition to provide rating agencies with more flexibility in how the ratings are presented.<sup>11</sup>

Subsection (b)(2) of the proposed rule change prohibits the use of a bond mutual fund volatility rating that does not incorporate the most recently available rating and that is not current.<sup>12</sup>

Subsection (b)(3) of the proposed rule change further prohibits the use of a bond mutual fund volatility rating that is not based exclusively on objective, quantifiable factors. This subsection also requires that the rating and the disclosure statement that accompanies it be clear, concise, and understandable. This requirement is intended to ensure that the rating information is presented in a way that is accessible and informative to the investor. Originally, this subsection also referred to the use of other factors that could be used to determine whether to issue the rating. Several commenters and the Commission noted that the language seemed to imply that, contrary to the language of the rule, subjective factors could also be considered in determining the rating. Accordingly, the NASDR filed Amendment No. 4 to remove this language.<sup>13</sup>

Subsection (b)(4) of the proposed rule change prohibits the use of bond mutual fund volatility ratings unless the supplemental sales literature containing the rating conforms to the disclosure requirements, which are described below.

Subsection (b)(5) of the proposed rule change prohibits members or associated persons of members from using bond mutual fund volatility ratings unless the entity that issued the ratings provides detailed disclosure on its rating methodology through a toll-free telephone number, a web site, or both.

#### *Disclosure Requirements*

Section (c) of the proposed rule change requires that certain disclosures accompany any bond mutual fund volatility rating used in supplemental sales literature by members or associated persons of members.

Specifically, subsection (c)(1) requires that supplemental sales literature containing a bond mutual fund volatility rating include a disclosure statement containing certain specified information required by the rule. It also permits the disclosure statement to contain any additional information that is relevant to an investor's understanding of the rating.

Subsection (c)(2) requires that supplemental sales literature containing a bond fund volatility rating include all other current volatility ratings that have been issued with respect to the same fund. Subsection (c)(2) also permits information concerning multiple ratings to be combined in the disclosure statement, provided that the applicability of the information to each rating is clear. This serves the purpose of avoiding redundant and potentially confusing information, and reduces the possibility that the rating could be buried or hidden in excess information.

Subsection (c)(3) requires that all bond mutual fund volatility ratings be contained within the text of the disclosure statement. The rating should not be located separately from the disclosure statement to avoid the risk that either could be read separately, or not at all, thereby increasing the possibility that the rating would not be understood in the context of the required disclosures.

Subsections (c)(3) (A)–(B) of the proposed rule change require that supplemental sales literature containing a bond mutual fund volatility rating disclose the names of the rating entity, the most current rating (accompanied by the date of that rating), and, if there is any change in the current rating from the most recent prior rating, an explanation of the change.

Subsection (c)(3)(C) of the proposed rule change requires that supplemental sales literature containing a bond mutual fund volatility rating describe the rating in narrative form. Under subsections (c)(3)(C) (i)–(vii), the narrative description must include: (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

<sup>11</sup> S&P notified the NASD that it is planned to revise the symbology it uses to label its bond fund risk ratings. The current symbology ranges from 'aaa' to 'ccc,' which S&P planned to convert to a scale ranging from 'S1+' to 'S6.' Letter from R. Clark Hooper, Executive Vice President, Disclosure and Investor Protection, NASD Regulation, to Sanford B. Bragg, Managing Director, Standard & Poor's, dated August 3, 1999.

<sup>12</sup> In this context, "current" describes the most recent calendar quarter ended.

<sup>13</sup> See *supra* note 8.

<sup>10</sup> See *supra* note 7.

of the rating; (v) a description of the types of risks the rating measures, such as 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.

#### Filing Requirement

The proposed rule change amends NASD Rule 2210 regarding communications with the public by adding new subsection (c)(3) to require sales literature containing bond mutual fund volatility ratings to be filed with the Department for review and approval at least 10 days prior to use. Members would not be required to file advertising and sales literature that had previously been filed and approved. Members filing sales literature containing bond mutual fund volatility ratings also must provide any supplemental information requested by the Department pertaining to the rating that has been assigned to the bond fund.

#### IV. Summary of Comments

The Commission received fourteen comment letters from 13 commenters concerning the proposal.<sup>14</sup> Of these commenters, eleven expressed conditional supports for the proposal,<sup>15</sup> and two opposed it.<sup>16</sup> One commenter cited a number of articles from periodicals in support of its position

<sup>14</sup> Letters to Jonathan G. Katz, Secretary, Commission from: Martin A. Corry, Director, Federal Affairs, AARP, dated December 14, 1998 ("AARP Letter"); Lisa G. Hathaway, Compliance Associate, American Funds Distributors, Inc., dated December 9, 1998 ("AFD Letter"); Barbara L.N. Roper, Director of Investor Protection, Consumer Federation of America, dated November 30, 1998 ("CFA Letter"); John B. Hammalian, Associate General Counsel, The Dreyfus Corporation, dated November 24, 1998 ("Dreyfus Letter"); Stephen A. Keen, General Counsel, Federated Investors, Inc., dated November 30, 1998 ("Federated Letter"); David H. Potel, Vice President and Deputy General Counsel, Fidelity Investments, dated November 27, 1998 ("Fidelity Letter"); Betsy Dotson, Director, Federal Liaison Center, Government Finance Officers Association, dated November 30, 1998 ("GFOA Letter"); Craig S. Tyle, General Counsel, Investment Company Institute, dated November 30, 1998 ("ICI Letter No. 1") and dated September 2, 1999 ("ICI Letter No. 2"); A. Michael Lipper, President, Lipper Advisory Services Inc., dated November 20, 1998 ("Lipper Letter"); James F. Des Mais, Assistant General Counsel, Legal, MFS Investment Management, dated November 30, 1998 ("MFS Letter"); Leo C. O'Neill, President and Chief Rating Officer, Standard & Poor's, dated November 30, 1998 ("S&P Letter"); Susan E. Woodward, dated November 25, 1997 ("Woodward Letter"); Henry H. Hopkins, Managing Director and Chief Legal Counsel, T. Rowe Price Associates, Inc., dated November 30, 1998 ("TRP Letter").

<sup>15</sup> AARP Letter, AFD Letter, CFA Letter, Federated Letter, Fidelity Letter, GFOA Letter, ICI Letter Nos. 1 and 2, Lipper Letter, MFS Letter, S&P Letter, and Woodward Letter.

<sup>16</sup> Dreyfus Letter and TRP Letter.

that the use of volatility ratings should only be allowed if appropriate safeguards are implemented.<sup>17</sup> Following are the issues raised, the commenters' positions, and the NASDR's and the Commission's responses.

#### Trial Period

Most commenters suggested that once the 18 month trial period ends the NASDR conduct a thorough assessment of the proposal to determine whether it should be amended, eliminated, or approved.<sup>18</sup> Federated believes the current ban on volatility rating disclosure is unnecessary and hopes that once the trial period concludes, the results will establish a basis for more reasonable, lenient guidelines.<sup>19</sup> The Commission believes that the trial period will provide the Department with a reasonable amount of time to consider all feedback concerning the use of these ratings, so that a fair and accurate assessment of the proposal's effectiveness can be made. The Commission expects that the Department will keep the Commission apprised of any problems that may arise in the rating process so that they may be promptly addressed.

#### Clarification of Certain Terminology

There was some debate among commenters on the use of certain terminology in the proposal. Most commenters focused on what term best describes risk.<sup>20</sup> One commenter stated that because the proposal does not restrict the type of entity that can provide ratings, they can be obtained from any entity as long as the ratings are based on objective criteria.<sup>21</sup> The commenter therefore suggested that, to help ensure the quality of the entities issuing the ratings, the NASDR consider providing guidelines (including specific definitions) for entities to follow.<sup>22</sup>

The NASDR contends that it has provide guidance, albeit indirectly, to entities providing ratings.<sup>23</sup> The proposed rule sets standards for NASD members and their associated persons by prohibiting their use of volatility rating unless the ratings conform to the rule.<sup>24</sup> The Commission agrees that the

<sup>17</sup> ICI Letter No. 2.

<sup>18</sup> See, e.g., AFD Letter, pp. 1-2 and ICI Letter No. 1, p. 2.

<sup>19</sup> Federated Letter, p. 1.

<sup>20</sup> See, e.g., AARP Letter, P. 1, Lipper Letter, p. 1, and Woodward Letter, pp. 2-3 (discussing the terms risk and volatility and the implications of their use).

<sup>21</sup> *Id.* at p. 3.

<sup>22</sup> Dreyfus Letter, pp. 3-4.

<sup>23</sup> NASDR response, pp. 3-4 (responding to a similar issue raised by a different commenter).

<sup>24</sup> *Id.* at p. 4.

proposal provides adequate guidance for NASD members and associated persons that will use these ratings in their supplemental sales literature. The Commission suggests, however, that the NASDR periodically assess the effectiveness of the proposal during the trial period to determine whether additional guidance is needed.

#### Additional Disclosure Requirements

Several commenters suggested that additional disclosure requirements were necessary to further clarify the meaning of the ratings and their limitations.<sup>25</sup> For example, MFS suggested that the rule require detailed disclosure on an entity's rating methodology and the underlying assumptions used to assess individual securities or types of securities in the fund's portfolio.<sup>26</sup> AARP suggested that a fund's investment philosophy and management be included in the disclosure statement. In response, the NASDR notes that these factors are already disclosed in the fund prospectus.<sup>27</sup> Another commenters suggested that a provision be added to require that the narrative description disclosure not only the type of risk being measured, but also how those risks relate to the stated investment goals of the fund.<sup>28</sup> The NASDR believes such a requirement would be inconsistent with the requirement that these ratings be based on objective, verifiable information.<sup>29</sup> Allowing the rating agency to provide its opinion on how the risks relate to a fund's investment objectives requires a subjective judgment that cannot be verified.<sup>30</sup>

Conversely, two commenters who opposed the proposal expressed doubt that any amount of disclosure would remedy the volatility ratings' inherent deficiencies.<sup>31</sup> For example, both commenters note that the proposal does not address the potential predictive nature of volatility ratings.<sup>32</sup> According to the NASDR, the possible predictive nature of the volatility ratings had been a factor in its current prohibition against the use of volatility ratings.<sup>33</sup> Moreover, this concern prompted the NASDR to

<sup>25</sup> See, e.g., AARP Letter, CFA Letter, and MFS Letter

<sup>26</sup> MFS Letter, p. 2.

<sup>27</sup> NASDR Response, p. 2.

<sup>28</sup> CFA Letter, p. 5.

<sup>29</sup> NASDR Response, p. 2.

<sup>30</sup> *Id.*

<sup>31</sup> Dreyfus Letter, pp. 1-2 (suggesting that concerns about availability of additional disclosure information should be directed to the member firm, not the rating agency) and TRP Letter, p. 2.

<sup>32</sup> Dreyfus Letter, pp. 1-2 and TRP Letter, p. 3.

<sup>33</sup> NASDR Response, p. 3.

eliminate from the original proposal the provision allowing subjective factors to be used in the calculation of the rating.<sup>34</sup>

The Commission has consistently supported requirements that attempt to make meaningful information available to the investor. In this case, however, if more information were added to the disclosure statement, it is possible that the investor could be overwhelmed with information that he fails to read any of the literature, or fails to focus on the key disclosures. The Commission is satisfied with the proposed disclosure requirements and the quality of information being made available to the investor.

#### Payment for Ratings

Some commenters contended that ratings prepared by independent third parties will be subject to conflicts of interest and potential misuse because the fund companies will pay for these ratings.<sup>35</sup> Two commenters strongly advocated a prohibition on the practice of buying ratings to ensure that the interests of the rating entity are independent of the interests of the fund being rated.<sup>36</sup> Lipper noted that the requirement that the fund disclose whether any payments were made for ratings should reduce, but will not completely eliminate, the incentive to shop for favorable ratings.<sup>37</sup> TRP noted that because funds will now have to pay for ratings, only those that are assured of the highest rating will attempt to procure one.<sup>38</sup> Conversely, Dreyfus contended that these ratings will not be generated if the rating agencies can not charge for them.<sup>39</sup>

The NASDR believes the proposal's prohibitions and substantial disclosure requirements are more than adequate to address potential conflicts of interest that may arise from the fact that the ratings are procured for a fee.<sup>40</sup> The Commission is concerned that rating agencies may be influenced by compensation received in providing fund volatility ratings. This concern is alleviated, however, by the requirement that the narrative description state whether consideration was paid in connection with the issuance of the ratings. Thus, the Commission is

satisfied that the rule addresses potential conflicts of interest.

#### Presentation of Volatility Rating

Some commenters stated that the volatility rating should not be buried or hidden in the text of the required disclosure statement.<sup>41</sup> Two commenters believed that burying the rating in the disclosure statement increases the chances that it will not be found, as few investors thoroughly examine disclosure statements.<sup>42</sup> Thus, they suggested displaying the rating in a conspicuous location, with a prominent reference to the disclosure statement for particulars, to increase the chances of it being examined by investors.<sup>43</sup>

The NASDR believes that the appropriate point of disclosure for the rating is within the text of the disclosure statement.<sup>44</sup> They note that the proposal requires any rating to be filed with the Department for pre-use review.<sup>45</sup> The Department will, therefore, have an opportunity to review whether the rating is prominently displayed or inconspicuous and determine whether to recommend changes to the disclosure statement prior to use.<sup>46</sup> The Commission notes that the NASDR has not outlined the standards for pre-use review. However, the Commission expects that the NASDR will conduct a thorough review of all submitted sales literature containing volatility ratings to ensure compliance with the disclosure requirements.

#### Applicability of proposal to "in-house" ratings

The NASDR requested comment on whether the descriptions of risk and volatility that mutual fund complexes currently provide for their own funds (*i.e.*, in-house ratings) should be subject to the provisions of the proposed rule change.<sup>47</sup> Two commenters suggested that risk or volatility ratings currently developed in-house resemble those provided by independent parties.<sup>48</sup> Because of the similarities between

these ratings and the fact that funds often fail to disclose the methodologies used to determine their in-house ratings, both commenters suggested that volatility ratings developed in-house should be subject to the disclosure requirements of the proposal.<sup>49</sup> Moreover, CFA believed that fund companies should not be allowed to use in-house risk or volatility ratings without also disclosing those ratings issued by independent third parties that conflict with the in-house rating.<sup>50</sup>

Conversely, several commenters opposed subjecting current in-house risk disclosures to the requirements of the proposal.<sup>51</sup> These commenters believed that in-house ratings are used primarily as an educational tool for investors to compare the different types of funds within a fund family.<sup>52</sup> Volatility ratings, they contend, are used by funds as a marketing tool to distinguish their fund from similar fund families.<sup>53</sup> Thus, according to ICI, in-house ratings do not present the same potential for abuse as volatility ratings and therefore should not be subject to the proposal.<sup>54</sup>

NASDR does not intend to apply the proposed rule to fund companies' in-house risk rating.<sup>55</sup> According to NASDR, these ratings 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>56</sup> The Commission preliminarily agrees with the NASDR that in-house risk ratings need not be subject to the proposed rule because they are primarily used by investors to distinguish between funds in a family of funds, but notes that the NASDR will reconsider at the conclusion of the trial period whether to apply the proposed rule to in-house ratings.<sup>57</sup>

One commenter also wanted the NASDR to clarify that the proposal only applied to open-end investment companies (*i.e.*, mutual funds) and not to other types of investment companies (*e.g.*, unit investment trusts).<sup>58</sup> For the trial period, the NASDR intends for the

<sup>34</sup> *Id.*

<sup>35</sup> See, *e.g.*, AFD Letter, CFA Letter, and ICI Letter No. 1.

<sup>36</sup> AFD Letter, pp. 1-2 and ICI Letter No. 1, p. 5.

<sup>37</sup> Lipper Letter, p. 1.

<sup>38</sup> TRP Letter, p. 2.

<sup>39</sup> Dreyfus Letter, p. 5 (noting that payment would only be a material issue if subjectivity were an element in the process).

<sup>40</sup> NASDR Response, p. 2.

<sup>41</sup> GFOA Letter, p. 3, S&P Letter, pp. 2-3, and Woodward Letter, p. 3.

<sup>42</sup> GFOA Letter and S&P Letter, *supra* note 41.

<sup>43</sup> GFOA Letter and S&P Letter, *supra* note 41.

<sup>44</sup> NASDR Response, p. 4.

<sup>45</sup> Proposed Rule 2210(c)(3) would require that sales literature containing these volatility ratings be filed with the Department for review and approval at least 10 days prior to use.

<sup>46</sup> NASDR Response, p. 4.

<sup>47</sup> See Securities Exchange Act Rel. No. 40627, *supra* note 4, at 60433.

<sup>48</sup> CFA Letter, p. 3 and S&P Letter, p. 3. CFA also noted that because in-house ratings and those of ratings agencies can be similar, fund companies could use in-house ratings in lieu of independent ratings with which they disagree.

<sup>49</sup> CFA Letter and S&P Letter, *supra* note 48.

<sup>50</sup> CFA Letter, p. 3.

<sup>51</sup> Dreyfus Letter, p. 5, ICI Letter No. 1, p. 7, and TRP Letter, p. 3.

<sup>52</sup> ICI Letter No. 1, p. 7 and TRP Letter, p. 3.

<sup>53</sup> ICI Letter and TRP Letter, *supra* note 52.

<sup>54</sup> ICI Letter and TRP Letter, *supra* note 52. TRP notes that these ratings have been filed with and reviewed by the NASD with no previously known objections.

<sup>55</sup> NASD Response, p. 2.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> ICI Letter No. 1, p. 6.

proposed rule to apply only to open-end investment companies.<sup>59</sup> The NASDR will decide at the conclusion of the trial period whether to apply the rule to all investment companies.<sup>60</sup> However, until then, the NASDR proposes to amend the definition of Bond Mutual Fund Volatility Rating to clarify that the proposed rule change only applies to open-end investment companies.<sup>61</sup> The Commission is satisfied with the NASDR's determination that, for the duration of the trial period, the proposal will apply only to open-end investment companies.

#### Prohibitions

Several commenters offered their conditional support for the proposal, provided that all or substantially all of the prohibitions remained intact.<sup>62</sup> After discussions with the Commission, however, the NASDR, has amended the proposal to remove text from two of the prohibitions that several commenters supported.<sup>63</sup> Amendment No. 4 removes the prohibition from subsection (b)(1) against using a single symbol, number, or letter to describe a rating. This amendment clarifies the intended application of this section and provides greater flexibility to members in the use of appropriate symbols for their ratings.<sup>64</sup> The amendment also removes text from subsection (b)(3) that might cause confusion regarding the requirement in subsection (b)(3) that the rating be based on objective, quantifiable factors.

The Commission believes that amended subsection (b)(1) provides the rating agencies with appropriate flexibility. Several commenters suggested that investors were more likely to rely on ratings conveyed in the form of a number or symbol without fully understanding their meaning or significance.<sup>65</sup> The Commission notes, however, that the proposal still requires that the sales literature include a description of the rating in narrative form. The description must include certain disclosures, which should decrease the likelihood of investor confusion concerning a rating's meaning.

Concerning amended subsection(b)(3), the Commission believes the language is now clear that subjective factors should

not be used to determine a rating.<sup>66</sup> The NASD stated that it eliminated subjective factors to ensure that any ratings issued during the trial period could be verified and replicated.<sup>67</sup> While most commenters agreed that only objective, quantifiable factors should be used to determine a rating, one commenter noted that this requirement would still allow fund entities to base their ratings on *different*, objective criteria.<sup>68</sup> Another commenter also suggested that the NASD address how it will monitor compliance with subsection (b)(3) and define what an "objective" factor is.<sup>69</sup>

NASDR believes it would be inappropriately constrictive to define what an "objective" factor is, other than to say that such factors should relate to information that is objectively determinable and should permit replication of ratings by third parties.<sup>70</sup> NASDR states that it will monitor compliance by requiring that all volatility ratings be submitted to its Department for pre-use review.<sup>71</sup>

The Commission believes that, during the trial period, rating agencies should be allowed to determine what qualifies as objective criteria, consistent with the NASDR's guidelines, and which objective criteria they should use to calculate the rating.<sup>72</sup> The proposal eliminates the use of subjective, qualitative factors, but does not prevent rating agencies from using their reasonable discretion in selecting which objective criteria to use to calculate a rating. The Commission reiterates that the onus is on the NASD member or associated person to make certain that all required information outlined in the proposal is disclosed so that the rating can be replicated and that the basis for any inconsistencies is readily apparent. The trial period should provide enough time to determine whether additional

standards or guidelines are needed to prevent investor confusion or minimize excessive variability among ratings of similar portfolios.

#### V. Discussion

As discussed above, the Commission finds the proposed rule change is consistent with the Act and the rules and regulations thereunder.<sup>73</sup> Specifically, the Commission believes that the proposed rule change is consistent with Section 15A(b)(6)<sup>74</sup> of the Act, which requires that the NASD adopt rules that are designed to remove impediments to and perfect the mechanism of a free and open market and national market system, and, in general, to protect investors and the public interest. The Commission believes that the proposed rule change will remove impediments to a free and open market by allowing independent third parties to issue ratings of bond mutual funds based on an evaluation of objective criteria regarding a fund's performance and characteristics. The Commission also believes the various disclosure requirements outlined in the proposal will protect investors and the public interest by providing the information necessary to make an informed decision about a particular bond fund.

The proposed rule change, by imposing certain prohibitions, disclosure, and filing requirements, is designed to permit members and associated persons of members to disseminate bond mutual fund volatility ratings is supplemental sales literature according to standards designed to prevent such ratings from being misleading, predictive, or otherwise inappropriate. The Commission finds that the 18 month trial period is sufficient time to implement the proposed rule change and to determine, based on participation and subsequent feedback, whether the process should continue unchanged or whether modifications are necessary.

The Commission finds that the amended definition of bond mutual fund volatility ratings provides appropriate guidance concerning the type of funds to which the interpretation would apply during the trial period. Given the array of investment vehicles falling within the term "bond mutual fund," Amendment No. 3 provides the necessary clarity on the scope of investments to which this rule applies.

<sup>73</sup> The Commission has considered the proposed rule's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

<sup>74</sup> 15 U.S.C. 78o-3(b)(6)

<sup>66</sup> But see GFOA Letter, p. 2 and Woodward Letter, p. 3 (stating that agencies should be allowed to use the tools they deem appropriate in assessing risk).

<sup>67</sup> NASDR Response, p. 5.

<sup>68</sup> TRP Letter, p. 2. TRP believes this lack of uniformity will ultimately lead to investor confusion, if similar bond funds receive different ratings.

<sup>69</sup> Dreyfus Letter, p. 4.

<sup>70</sup> NASDR Response, p. 3.

<sup>71</sup> *Id.*

<sup>72</sup> The Commission recognizes that without providing an exhaustive list of objective criteria for the agencies to use, similarly-situated bond funds may receive different ratings. However, the Commission is satisfied that the disclosure statement, which should include a description of the criteria and methodologies used, will provide the Department and investors with the requisite information to replicate the rating. Thus, the potential lack of uniformity in ratings and potential investor confusion should be mitigated by the proposal's required disclosures.

<sup>59</sup> NASDR Response, p. 4.

<sup>60</sup> *Id.*

<sup>61</sup> See *supra* note 7.

<sup>62</sup> AFD Letter, pp. 1-2, ICI Letter No. 1, p. 4 and MFS Letter, p.2.

<sup>63</sup> Amendment No. 4, *supra* note 8.

<sup>64</sup> *Id.* at p. 1.

<sup>65</sup> AFD Letter, p. 2, CFA Letter, p. 4, and ICI Letter No. 1, pp. 2-3.

The Commission also finds that the prohibitions and Amendment No. 4 strike an appropriate balance. The proposed rule change and the amendment refrain from imposing a specific standard on descriptions (*i.e.*, removing the prohibition against use of a single symbol, number, or letter) or calculations of ratings in recognition of the fact that there is no specified or uniform range of information used by all rating entities, and that rating entities should be allowed to develop competing methods and models of assessing volatility. The amendment also eliminates the use of subject factors from the volatility calculation, thereby reducing the potential variability of ratings, and limiting the ability of funds to “shop around” for the most favorable rating.

The proposal, however, also imposes certain disclosure requirements that should assist investors in determining whether a fund is appropriate for them based on their investment objectives. The disclosure required by subsections (c)(3)(C)(i)–(vii) of the rule will help inform investors of certain potential limitations of a rating (*e.g.*, that a rating may have been paid for, may measure only a certain type of risk or volatility, may not reflect a comparison with all funds of a given class or peer group, and may not reflect a fund’s current portfolio). The Commission believes that the requirement that any change in the rating and the reasons for the change be disclosed is important for investors in making informed investment decisions. Thus, the Commission finds that the proposed rule change, in providing access to this supplemental information, should enable investors to obtain answers to questions regarding the meaning of the rating or how it is calculated or derived.<sup>75</sup>

The Commission also finds that the requirement that sales literature containing volatility ratings be filed at least 10 days prior to use should provide the Department with sufficient time to review the sales material for compliance with the proposal’s requirements. The Commission expects a thorough review of all sales literature to be conducted and accurate records to be maintained by the NASDR to facilitate the possible assessment of the rating process.

Finally, the Commission believes this proposal represents the best mechanism for disseminating information about bond mutual funds risk to investors.

<sup>75</sup> The Commission emphasizes that sales literature is no substitute for a fund’s prospectus and, if investors have not received one, they should request a current prospectus to review in conjunction with the sales materials.

Risk ratings are an important source of information for investors because they can potentially determine the likelihood of gains or losses in the market value of a particular fund. As such, the Commission believes they can be useful tools for investors to aid in making informed investment decisions. Thus, the Commission finds that it is in the public interest to facilitate the dissemination of this information in an environment that encourages disclosure and enhances competition.

The Commission also finds good cause for approving proposed Amendment Nos. 3 and 4 prior to the thirtieth day after the date of the publication of notice of filing thereof in the **Federal Register**. The amendments remove ambiguous language that could hinder understanding of the proposal’s applicability by clarifying which types of funds can be subject to the ratings process. The amendments also specify what types of criteria can be used to determine the ratings, while simultaneously providing some flexibility in how the rating agencies provide their services. The Commission believes that these amendments should help make the ratings provided more objective and enhance the disclosures made in the sales literature. Furthermore, the Commission finds that these amendments should enhance competition among those entities issuing the ratings. Thus, the Commission believes the approval of the amendments should not be delayed. For these reasons, the Commission finds good cause for accelerating approval of the proposed rule change, as amended.

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 3 and 4, including whether the amendments are 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, D.C. 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 offices of the NASD. All submissions should refer to the file

number in the caption above and should be submitted by March 29, 2000.

## VI. Conclusion

For the above reasons, the Commission finds that the proposed rule change is consistent with the provisions of the Act, and in particular with Section 15A(b)(6).

*It is Therefore Ordered*, pursuant to Section 19(b)(2)<sup>76</sup> of the Act, that the proposed rule change (SR–NASD–97–89), be, and hereby is, approved for an 18 month trial period, which ends on August 31, 2001. Amendment Nos. 3 and 4 are also approved on an accelerated basis for an 18 month trial period, which also ends on August 31, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>77</sup>

**Margaret H. McFarland**,  
*Deputy Secretary*.

[FR Doc. 00–5557 Filed 3–7–00; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–42481; File No. SR–NASD–00–7]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Extension of Certain Nasdaq Services and Facilities Until 6:30 P.M. Eastern Time

March 1, 2000.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b–4 thereunder,<sup>2</sup> notice is hereby given that on February 29, 2000, the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, The Nasdaq Stock Market, Inc. (“Nasdaq”) filed with the Securities and Exchange Commission (“Commission” or “SEC”) the proposed rule change as described in Items I, II and III below, which Items have been prepared by Nasdaq. Nasdaq filed the proposal pursuant to Section 19(b)(3)(A) of the Act,<sup>3</sup> and Rule 19b–4(f)(6) thereunder,<sup>4</sup> which renders the proposal effective upon filing with the

<sup>76</sup> 15 U.S.C. 78s(b)(2).

<sup>77</sup> 17 CFR 200.30–3(a)(12).

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

<sup>2</sup> 17 CFR 240.19b–4.

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>4</sup> 17 CFR 240.19b–4(f)(6).