Comment Letter on NASD Proposal for Bond Fund Volatility Ratings, March 2000

March 24, 2000

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

RE: Accelerated Approval of Amendment No. 4 to the Proposed Rule Change on a Temporary Basis Relating to Bond Mutual Fund Volatility Ratings
(File No. SR-NASD-97-89)

Dear Mr. Katz:

The Investment Company Institute[1] is writing to express its views regarding Amendment No. 4 to NASD Regulation Inc.'s proposed rule change that was recently approved by the Commission to permit bond mutual fund volatility ratings in supplemental sales literature for an 18-month trial period.[2] Amendment No. 4, which received accelerated approval from the Commission, removes the prohibition against using "a single symbol, number or letter" to describe the volatility rating. For the reasons discussed below, the Institute opposes this change.[3]

There has been extensive analysis and debate regarding bond fund volatility ratings since the NASD issued a Notice to Members seeking comment on their use in supplemental sales literature over three years ago.[4] While the Institute has continually expressed serious reservations about the use of these ratings in mutual fund sales material, we generally supported NASDR's proposal to permit volatility ratings for a trial period, based on the proposed conditions on their use.[5] These important safeguards proposed by NASDR, including the requirement that volatility ratings must be solely in narrative form, addressed many of the rating's potential hazards. Removing the prohibition on the use of a single symbol, number or letter, however, eliminates this crucial safeguard for investor protection.

As we have stated previously, 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, letter or number to make this crucial decision.[6] In fact, an Institute research survey on shareholders' assessment of bond fund volatility ratings showed that the potential for such ratings to mislead investors was accentuated by the use of numbers, symbols or stock phrases to designate the ratings.[7]

In responding to commenters' concerns that investors are more likely to rely on ratings conveyed in the form of a number or symbol without fully understanding their meaning or significance, the Commission noted that the requirement to provide a narrative description of the rating along with a number or symbol, together with certain disclosures "should decrease the likelihood of investor confusion concerning a rating's meaning." We disagree. Notwithstanding the requirement to also provide a narrative description of these ratings, the presence of rating symbols or numbers will tend to discourage an investor's thorough assessment of a bond fund's risk, and instead entice the investor to circumvent this analysis by relying on the symbol as the best depiction of risk.

The Commission's rationale for removing the single symbol prohibition is "to provide rating agencies with more flexibility in how the ratings are presented."[8] We do not believe this prohibition would impair rating agencies' flexibility to such a degree to warrant diminishing investor protection. At most, the prohibition on the use of single symbols would require rating agencies to include effective narrative descriptions of volatility that would appropriately describe their rating, without permitting reliance on a single symbol to bolster their description. We believe that any resulting loss in "flexibility" is an insignificant inconvenience when weighed against the preservation of such a crucial investor protection.

Allowing the use of single symbols or numbers to describe volatility ratings during the pilot program thus caters to the needs of the rating agencies at the risk of compromising investor protection. This weakening of the conditions on the use of bond fund volatility ratings makes it even more important for the NASD to undertake a comprehensive review of the proposal at the end of the pilot program and permit public comment before determining whether to allow volatility ratings in supplement sales literature on a permanent basis.

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We appreciate the opportunity to comment on this very important aspect of the pilot program. If you have any questions regarding our comments, please do not hesitate to contact me at 202/326-5824 or Dore Zornada at 202/326-5819.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

cc: Annette Nazareth, Director, Division of Market Regulation
Paul F. Roye, Director, Division of Investment Management
Securities and Exchange Commission

Mary L. Schipiro, President
R. Clark Hooper, Executive Vice President, Disclosure and Investor Protection
Thomas M. Selman, Vice President, Investment Companies/Corporate Financing
NASD Regulation, Inc.

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,021 open-end investment companies ("mutual funds"), 496 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.728 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

[2] SEC Release No. 34-42476 (Feb. 29, 2000), 65 Fed. Reg. 12306 (March 8, 2000).

[3] In order to clarify that volatility ratings can be based only on objective factors, Amendment No. 4 also removes language in subsection (b)(3) that commenters found confusing on this point. The Institute supports this change.

[4] NASD Notice to Members 96-84 (December 1996).

[5] See Letter from Craig S. Tyle, General Counsel, ICI, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Nov. 30, 1998 ("ICI Letter").

[6] See ICI Letter at 4.

[7] Shareholder Assessment of Bond Fund Risk Ratings, Report to NASD Regulation, Inc. (October 1997) at 7-10, 31-36.

[8] A footnote to this rationale indicates that at least one rating agency plans to modify its symbols for volatility ratings. While this modification might reduce the risk that investors would confuse volatility ratings with credit ratings, it does not alleviate our concerns regarding the inherently misleading nature of symbolic ratings.

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