

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 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.

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### **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).<sup>6</sup> 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 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.<sup>7</sup> 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.<sup>8</sup>

*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.<sup>9</sup> 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.<sup>10</sup>

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 2210(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

<sup>7</sup> *Id.*

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

<sup>9</sup> See footnote 6, *supra*.

<sup>10</sup> See footnote 8, *supra*.

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