Comment Letter on NASDR Bond Fund Volatility Program, September 2001

September 20, 2001

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

Re: Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 by the National Association of Securities Dealers, Inc. to Extend the Expiration Date of Rules Concerning Bond Mutual Fund Volatility Ratings
(File No. SR_NASD-2001-49)

Dear Mr. Katz:

The Investment Company Institute[1] is writing to express its views regarding NASD Regulation, Inc.'s proposed rule change to extend the expiration date of the pilot program permitting bond mutual fund volatility ratings in supplemental sales literature to August 31, 2003.[2] Based on the lack of participation by fund groups in the pilot program and our ongoing concerns with the use of bond fund volatility ratings, we oppose the extension of the pilot program and recommend that NASDR prohibit the use of these ratings altogether.

The 18-month trial period provided interested fund groups an ample opportunity to use bond fund volatility ratings in their supplemental sales literature. However, very few fund groups actually used these ratings during the pilot program, indicating a widespread lack of interest in the use of volatility ratings.[3] In addition, the Institute has continued concerns about the use of these ratings in fund sales literature[4] and the intrinsic limitations of the ratings process itself.[5] Based on these concerns and the absence of broad-based support for the ongoing use of volatility ratings, we believe that their use should be prohibited and that the pilot program should not be continued.

Nevertheless, if the pilot program is extended, it is important that all of the critical investor protections of the first pilot program remain intact. Our support for the initial pilot program was conditioned on the presence of these safeguards, and we believe that it is imperative that they not be weakened. The Release indicates that no changes will be made to the conditions on the use of volatility ratings, and we believe that any arguments to weaken these restrictions should be rejected to avoid placing investors at risk.

In fact, we recommend that the safeguards be strengthened to prohibit the use of a single symbol, number or letter to describe a volatility rating. This prohibition, which was included in the original rule proposal, is a crucial safeguard for investor protection.[6] As we have previously stated, 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 this crucial decision.[7] Allowing the use of single symbols or numbers to describe volatility ratings thus caters to the needs of the rating agencies at the risk of compromising investor protection.

At the end of the extended trial program, it is important that NASDR proceed cautiously and not automatically extend the rule for an indefinite period or adopt it on a permanent basis. In particular, NASDR should undertake a comprehensive review of the pilot program, publish the results, and solicit further comment before determining whether to allow volatility ratings in supplement sales literature on a permanent basis.

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The Institute appreciates the opportunity to comment on this important issue. If you have any questions regarding our recommendation, please call me at 202/326-5824 or Dore VanSlyke Zornada at 202/326-5819.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

cc: Paul F. Roye
Director
Division of Investment Management
Securities and Exchange Commission

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NASD Regulation, Inc.

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,730 open-end investment companies ("mutual funds"), 481 closed-end investment companies and 7 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.864 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

[2] See 66 Fed. Reg. 45350 (August 28, 2001) ("Release"). Although the rule change is effective immediately, the Commission is soliciting comments from interested persons. The expiration date of the original pilot program was August 31, 2001. See NASD Notice to Members 00-23 (April 2000).

[3] We are aware of only one fund group that has actually used bond fund volatility ratings in its supplemental sales literature. The Release states that six filings to use these ratings were made to NASDR as of July 2001. See Release at 45350.

[4] The Institute has continually expressed serious reservations about the use of these ratings in mutual fund sales literature. See, e.g., Letter from Craig S. Tyle, General Counsel, ICI, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated November 30, 1998; Letter from Craig S. Tyle, General Counsel, ICI, to Mary L. Schapiro, President, NASD Regulation, Inc., dated October 29, 1997; Letters from Paul Schott Stevens, Senior Vice President and General Counsel, ICI, to Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated September 10, 1997 and February 24, 1997.

[5] See, e.g., ANDREW FIGHT, THE RATINGS GAME, (2001) (examining the power of ratings agencies and their limitations; highlighting events that raise questions as to rating agencies' accountability and the level of service they provide); Sandra Ward, Grade Inflation: Why a Triple-A Money Fund May Not be Immune to Credit Woes, BARRON'S, August 30, 1999 (noting fact that a rating agency continued to confer its highest rating on a fund that held a downgraded and defaulted security); Charles Gasparino, S&P's Caveat on Ratings: Don't Blame Us, THE WALL STREET JOURNAL, August 20, 1999 (describing S&P's policy to require contractual agreements that ratings are only opinions, underscoring the fact that rating agencies have no legal responsibility for the accuracy or quality of their ratings).

[6] This prohibition was subsequently removed by 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), SEC Release No. 34-42476 (February 29, 2000), 65 Fed. Reg. 12306 (March 8, 2000).

[7] See Letter from Amy B.R. Lancellotta, Senior Counsel, ICI, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 24, 2000.