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Comment Letter on Shareholder Risk Assessment Research, September 1997

September 10, 1997

Mr. Frank G. Zarb
Chairman, President &
Chief Executive Officer
National Association of Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006

Dear Mr. Zarb:

I am writing to underscore the Investment Company Institute's strong opposition to NASDR's changing its long-standing rules to permit the use of risk ratings in bond fund sales literature, either permanently or during some trial period.

At first blush, the idea of risk ratings has great appeal. After all, risk ratings promise to provide an all-encompassing measure of risk. They promise to predict the future—or, in the euphemism of the rating agencies, to "look forward"—in terms of fund performance. They promise to simplify greatly the investing process. But risk ratings promise far more than they can deliver. No rating can capture all aspects of bond fund risk—neither the risk of a fund itself, nor risk as it relates to an individual investor, nor market contingencies yet to be.

Will investors benefit or be misled if NASDR authorizes funds to be sold to them on this basis? The Institute's research with actual mutual fund shareholders, the results of which are being submitted to NASDR today, demonstrates that investors will be misled by risk ratings. The research indicates the following: Most investors will not understand the nature and limitations of risk ratings. They nonetheless will rely upon them widely and to the exclusion of other relevant information about a fund's risk. Risk ratings will bias many investors to invest in "low risk" funds even when such funds are less appropriate to their investment goals. Investor expectations about the rating process and rating services are sharply at odds with the risk rating systems actually being urged on NASDR.

The only parties that would benefit from a change in NASDR's rules are the commercial suppliers of risk ratings, which would profit from selling their opinions in a new market while insulated from any normal securities law liability in the event their ratings prove to be inaccurate. The comment record contains little to justify a change in NASDR's rules as evidenced in the Institute's analysis of the comments being filed today. Even those commenters who appear to support risk ratings express serious concerns about how they will be marketed and used, particularly in the absence of any regulation of risk rating agencies and risk rating systems. But for the Institute's survey research with fund shareholders, the comment record contains nothing about how individual investors—whose interests must be paramount—are likely to understand and use such ratings.

It has been suggested that NASDR might permit bond fund sales literature to include risk ratings on a trial basis. Presumably this would necessitate the NASDR going through the formalities of a full rulemaking with respect to, for example, various disclosure requirements. It is not apparent what NASDR might seek to determine in such a trial or how it would do so. The Institute, in its research, already has provided a detailed perspective on fund investors as users of such ratings. Moreover, as a practical matter, once NASDR authorizes the use of such ratings, it will be all but impossible to rescind that authority.

Most importantly, the concerns that the Institute and others have about how risk ratings will develop over time simply cannot be evaluated during a test period. A test period likely would focus on the three current providers of risk ratings, which predictably would be on their "best behavior" during the trial run. At the end of the test period, authorization from NASDR would open the door not only to established NRSRO's, but to any new entrant, likely precipitating a "race to the bottom" in the quality of risk ratings. It is ironic that at a time when the SEC is moving to tighten requirements on credit rating agencies qualified as NRSRO's, NASDR should consider opening wide the door to any and all suppliers of risk ratings, without any qualifications whatsoever.

If the use of risk ratings is authorized, a rating assigned to a bond fund could prove to be as spectacularly incorrect as the highest short-term credit ratings given to Orange County notes by two of the credit rating agencies. This result would harm the investing public, damage the reputation of the mutual fund industry and broker-dealers who sold the funds, and would be an enormous embarrassment to NASDR for authorizing the use of risk ratings.

The Institute has opposed the use of risk ratings in sales literature since the concept was first introduced in 1993. On the basis of the public comments and most especially the investor research now available to NASDR, we are even more firmly opposed. We appreciate your consideration of the Institute's views.

Very truly yours,

Matthew P. Fink
President

cc: Mary L. Schapiro, President
NASD Regulation, Inc.

Elise B. Walter, Executive Vice President
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