[Release No. 34–38369; File No. SR–NASD–96–39]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Amending the Requirements for the Use in Advertisements and Sales Literature of Investment Company Rankings

March 5, 1997.

I. Introduction

On October 17, 1996,[1] the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') submitted to the Securities and Exchange Commission (''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[2] and Rule 19b–4 thereunder,[3] a proposed rule change to amend the requirements for the use in advertisements and sales literature of investment company rankings.

Notice of the proposed rule change as amended, together with the substance of the proposal, was published for comment in Securities Exchange Act Release No. 37987 (November 25, 1996), 61 FR 64185 (December 3, 1996) (''Notice''). Four comment letters were received on the proposal. This order approves the proposed rule change.

II. Description

In 1994, the Commission approved what is now IM–2210–3 of the NASD Conduct Rules, which provides guidelines for the use of rankings in investment companies' advertisements and sales literature (''Guidelines'').[4] Among other things, the Guidelines require that all rankings used in advertising and sales literature by member firms to promote non-money market mutual fund performance include rankings over one, and, if available, five and ten year periods. Prior to the guidelines, there were no specific standards for the use of rankings. Members generally had selected rankings for whatever time period produced the most favorable rankings for an investment company.

Since the approval of the Rankings Guidelines, the staff of NASD Regulation, Inc. (''NASDR'') has considered whether to allow for greater flexibility in the use of time periods other than those prescribed by the Guidelines. The staff noted that some rankings, which are based on adjusted total return to reflect criteria and methodologies established and imposed by the ranking entities, use time periods that do not meet the three specifically prescribed time periods contained within the Guidelines.[5] NASDR staff determined that the Guidelines, as originally approved, should be revised consistent with the original goal that would prevent selectivity of time periods. The NASD filed a proposed rule change to IM–2210–3[6] of the NASD's Conduct Rules to allow for the use in advertisements and sales literature of investment company rankings that represent short, medium and long term performance.

The rule change revises subparagraphs (2) (B) and (C) to paragraph (d) of IM–2210–3. The rule change clarifies that the use of one, five and ten year time periods is required if such time periods are published by the ranking entity.[7] If rankings for the required time periods are not published by the ranking entity, the rule change provides that rankings representing short, medium and long term performance must be provided in place of rankings for the required time periods.[8]

The rule change also replaces the phrase ''in the category'' in subparagraphs (2) (B) and (C) with the phrase ''relating to the same investment category,'' to clarify that when members provide rankings for advertisements and sales literature, rankings for the prescribed time periods must be for the same investment category or subcategory as the total return ranking that is being accompanied by the prescribed ranking.

III. Summary of Comments

The Commission received four comment letters, three of which supported the proposed rule change, and one that did not, and a response to the comment letters.[9] The comment letter from Lipper Analytical Services, Incorporated (''Lipper'') divides its criticisms into several different areas. Lipper stresses the importance of having one, five and ten year performance periods as a way to stop ranking companies from ''cherry picking'' performance periods in order to maximize attractiveness of the funds. Lipper believes that the fact that some funds do not have one, five or ten year histories is sometimes very important to investors and that lowering the ''barriers'' will not alert the investor to the potential of an unseasoned mutual fund.

Lipper next addresses the validity of the categories of funds that are ranked. Lipper says that funds with similar investment characteristics should be compared to each other but that comparing dissimilar funds could be misleading. In addition, Lipper argues that the one year measure is important to investors who may want to know the short term performance of a fund and to different mutual fund participants who may have different time requirements. Lipper adds that all performance based advertising, including returns, rankings and ratings, should be on the same basis. Lipper also argues against the use of a single number that represents risk for an investment company, saying that investors do not believe there can be a useful single measure of risk. Any measure that involves the use of the word ''risk'' should have an explanation of the calculation procedures. Lipper says that any measure that compares funds with securities indices and other indices risks comparing unlike entities. Last, Lipper agrees that there should be some improvement in the disclosure of fund advertising to investors, and suggests that performance of funds should be measured in rising and falling market conditions.

The comment letter from the Investment Company Institute (''ICI''),

[1] On November 21, 1996, the NASD filed Amendment No. 1 with the Commission. The amendment clarified that rankings based on yield may be based on periods of less than one year. The amendment also made technical amendments to the text of the rule. *See* Letter from John Ramsay, Deputy General Counsel, NASD Regulation, Inc. to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated November 20, 1996.

[2] 15 U.S.C. 78s(b)(1).

[3] 17 CFR 240.19b–4.

[4] Securities Exchange Act Release No. 34354 (July 12, 1994), 59 FR 36461 (July 18, 1994).

[5] For example, one ranking entity has developed a ranking system that summarizes an investment company's risk/reward profile for three, five, and ten year periods. This system provides a composite ranking that seeks to measure how well an investment company has balanced return and risk in the past.

[6] NASD Manual, Conduct Rules, Interpretative Material of the Rules of the Association (CCH), IM–2210–3.

[7] The Guidelines define ''Ranking Entity'' as ''* * * any entity that provides general information about investment companies to the public, that is independent of the investment company and its affiliates, and whose services are not procured by the investment company or any of its affiliates to assign the investment company a ranking.''

[8] In its discussions of how the terms ''short,'' ''medium'' and ''long term'' might be interpreted, NASDR staff considered time frames of 1–4 years, 5–9 years and 10 years or more, respectively, as an acceptable interpretation.

[9] *See* letters to Jonathan G. Katz, Secretary, SEC, from Banc One Corporation, Investment Company Institute, and Morningstar, Incorporated, dated December 24, 1996, December 24,1996, and December 20, 1996 respectively; letter to Margaret H. McFarland, Deputy Secretary, SEC, from Lipper Analytical Services, Incorporated, dated December 23, 1996; and letter to Katherine A. England, Assistant Director, Market Regulation, SEC, from John Ramsay, Deputy General Counsel, NASDR, dated January 23, 1997 (''NASDR letter'').

although in support of the proposed rule change, has two comments on the content of the filing. The ICI states that is does not believe that the NASDR's suggestions of 1–4 years, 5–9 years and 10 years or more [10] are intended as definitions of short, medium and long, but rather as an interpretation by the NASDR staff of the relative lengths of time for each period. In addition, ICI states that the rule change does not explicitly address whether a NASD member could use a short or medium term ranking for a fund that has been in existence for at least one or at least five years and for which rankings for the specified time periods are not published by the ranking entity, but it supports that result.

IV. Discussion

The Commission finds that the proposed rule change is consistent with Section 15A(b) of the Act and the rules and regulations thereunder, and, in particular, with the requirements of Section 15A(b)(6)[11] that the rules of an association be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, and, in general, to protect investors and the public. The rule change provides a flexible framework within which ranking entities using different methodologies can provide useful information to investors in a way that is not harmful or misleading and that still prevents selectivity of time periods. The Commission believes that performance-adjusted rankings which use different time periods than those prescribed by the Guidelines can help investment company investors make informed investment decisions if presented in a way that is not misleading.

The Commission believes that a concern about selectivity of time periods is adequately addressed by the rule change. The Commission notes that under the proposed rule change, short, medium and long-term rankings can only be used if one, five and ten year rankings are not available. The Commission also notes that short, medium and long term rankings are still uniform in nature and do not allow Ranking Entities to randomly choose any time periods they want.

Lipper raises a valid concern about only comparing similar funds, but the Commission believes that concern is addressed by the proposed rule change. The rule change clarifies language in the rule by stating that rankings for prescribed time periods must be "* * * by the same Ranking Entity, relating to the same investment category, and based on the same time period." The NASD, further clarifying the "relating to the same investment category" language, stated that rankings for the prescribed time period must be for the same investment category or subcategory as the total return ranking that is being accompanied by the prescribed ranking.[12]

The Commission notes Lipper's concern that a one year performance ranking is important to investors who want to know the short-term performance of a fund. The Commission believes that this concern is adequately addressed by the requirement that one, five and ten year time periods must be used if they are published by the ranking entity.[13] The Commission also believes that Lipper's concern that different mutual fund participants have different time requirements is addressed by the proposed rule change in that it now permits the use of time periods other than one, five and ten years in certain instances.[14]

The Commission also realizes that there may be instances where non-disclosure of certain factors could cause the use of a ranking to be misleading, notwithstanding that the ranking is in technical compliance with the Ranking Guidelines.[15] NASD recognized these concerns and stressed that NASD rules governing communications with the public require that all advertising and sales literature submitted for review not be misleading,[16] and that those rules give the NASDR broad authority to prohibit the use of the misleading ranking.[17]

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[18] that the proposed rule change (SR–NASD–96–39) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[19]

Margaret H. McFarland,

Deputy Secretary.

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[10] The Commission notes that the correct time period suggested by the NASD was 5–9 years for he medium time period and that a mistake was made in the Notice, which reads "5–5 years."

[11] 15 U.S.C. 78*o*–3

[12] *See* Notice and NASDR letter.

[13] *See* NASDR letter.

[14] The Commission believes that the concern about risk-based rankings is not relevant to this proposed rule change because this filing does not deal with the method of calculating the performance-based rankings themselves, other than the length of time over which the rankings must be calculated. The Commission also believes that the suggestion that performance should be measured over rising and falling market conditions is not relevant to this proposed rule filing because this filing is concerned with the length of the time period for measuring performance.

[15] For example, if a one-year ranking is used that coincides with the tenure at the firm of a particular fund manager, the fact that the fund manager has changed could be relevant. Similarly, if a three-year ranking is used that encompasses a change in fund managers at the firm, the fact that the ranking covers a period with more than one fund manager could be relevant.

[16] NASD Conduct Rule 2210(d)(1)(A) states that "[a]ll member communications with the public should provide a sound basis for evaluating the facts in regard to any particular security * * *. No material fact or qualification may be omitted if the omission * * * would cause the advertising or sales literature to be misleading." NASD Conduct Rule 2210(d)(1)(B) further states that "[e]xaggerated, unwarranted or misleading statements or claims are prohibited in all public communications of members."

[17] *See* Amendment #1, filed November 21, 1996 and NASDR letter.

[18] 15 U.S.C. 78s(b)(2).

[19] 17 CFR 200.30–3(a)(12).

DEPARTMENT OF STATE

[Public Notice 2516]

Advisory Committee on Historical Diplomatic Documentation; Notice of Meeting

The Advisory Committee on Historical Diplomatic documentation will meet in the Department of State, March 18–19, 1997 in Conference Rooms 1205 and 1406.

The Committee will meet in open session from 1:00 p.m. on the afternoon of Tuesday, March 18, 1997, until 5:00 p.m. The remainder of the Committee's sessions from 9:00 a.m.—5:00 p.m. on March 19, 1997, will be closed in accordance with Section 10(d) of the Federal Advisory Committee Act (P.L. 92–463). It has been determined that discussions during these portions of the meeting will involve consideration of matters not subject to public disclosure under 5 U.S.C. 552b(c)(1), and that the public interest requires that such activities will be withheld from disclosure.

Questions concerning the meeting should be directed to William Z. Slany, Executive Secretary, Advisory Committee on Historical Diplomatic Documentation, Department of State, Office of the Historian, Washington, DC 20520, telephone (202) 663–1123, (e-mail histoff@ix.netcom.com).

Dated: February 20, 1997.

William Z. Slany,

Executive Secretary.

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