

MEMO# 9248

September 16, 1997

ICI SUBMITS INVESTOR RESEARCH AND SUPPLEMENTAL COMMENTS ON RISK RATINGS TO NASDR

1 The ICI submitted initial comments in opposition to the use of such ratings in February, responding to NASDRs request for comment on the use of bond fund risk ratings in supplemental sales literature. See Memorandum to Board of Governors No. 10-97, Advertising Subcommittee No. 9-97, SEC Rules Committee No. 21-97 and Unit Investment Trust Committee No. 11-97, dated February 25, 1997. 2 The research report submitted to NASDR included preliminary results based on interviews with 421 mutual fund shareholders. An additional 179 interviews are being completed so that the total number of interviews for the full study will be 600. It is not expected that the additional interviews will materially change the findings submitted to NASDR. The report submitted to NASDR containing the preliminary results is not attached; the final report is expected to be completed by October 31, 1997, at which time it will be distributed to members. [9248] September 16, 1997 TO: BOARD OF GOVERNORS No. 53-97 ADVERTISING SUBCOMMITTEE No. 32-97 SEC RULES COMMITTEE No. 90-97 UNIT INVESTMENT TRUST COMMITTEE No. 56-97 RE: ICI SUBMITS INVESTOR RESEARCH AND SUPPLEMENTAL COMMENTS ON RISK RATINGS TO NASDR

The ICI recently submitted to NASD Regulation, Inc. (NASDR) the preliminary results of a research survey focusing on shareholders assessment of bond fund risk ratings and a supplemental letter responding to comments submitted to NASDR by risk rating proponents.¹ In addition, ICI President Matthew Fink sent a letter to Frank Zarb, president of the NASD, expressing strong opposition to allowing the use of such ratings. A copy of these materials are attached and summarized below. The NASDR board will consider whether to permit the use of bond fund risk ratings in supplemental sales literature at a meeting scheduled for September 22. Research on Shareholders Assessment of Bond Fund Risk Ratings The ICI recently surveyed current mutual fund shareholders to determine how well they understand bond fund risk ratings, how they would use them and their expectations about them. The results of the survey, which are summarized in the attached letter, 2 substantially support concerns expressed by the ICI and others about the use of bond fund risk ratings. The results are as follows: Most mutual fund shareholders find risk ratings to be very appealing and view such ratings as simplifying the evaluation of bond fund risk and as being suited to investors like themselves. If made available, most survey participants would rely upon them when considering the purchase of a bond fund. Thus, risk ratings would displace other more relevant information (such as a narrative description of a funds risks). Most investors do not understand risk ratings. Less than half of the survey respondents (41 percent) recognized

that the rating provided information about interest rate risk -- the basic function of the rating. Risk ratings will likely lead many investors to invest in "low risk" rated funds, even though such investments may be inappropriate given their long-term investment goals. Shareholders expectations about bond fund risk ratings were inconsistent with how the ratings would actually operate. For example, 72 percent of the survey participants expected that every bond fund would be rated; 81 percent expected to be able to compare funds based upon their risk ratings; 74 percent thought that an independent third party would review the rating methodology; and 64 percent expected the rating agencies to be government regulated. Supplemental Comment Letter The ICI submitted a supplemental letter to respond to the comments filed with NASDR supporting the use of bond fund risk ratings. The letter reiterates the ICIs concerns that risk ratings, rather than providing useful information, would be powerfully misleading and, thus, "will hurt, not help, bond fund investors." The letter states that the burden is on those who advocate changing NASDRs long-standing prohibition against the use of such ratings to demonstrate that they are not likely to mislead investors, that they comport with NASDR standards concerning predictions or opinions about securities offerings, that specific disclosure requirements can be implemented effectively, and that such disclosure requirements are adequate to protect investors. The letter concludes that this burden clearly has not been met and that the comment record fails to answer the very substantial objections raised by the ICI as well as other commenters. Letter to NASD President Frank Zarb In a letter to NASD President Frank Zarb, ICI President Matthew Fink underscored the ICIs strong opposition to the use of risk ratings in bond fund sales literature, either permanently or during some trial period. The letter asserts that the only parties that would benefit from a change in NASDRs rules to permit the use of such ratings are the commercial suppliers of the ratings, which would profit from selling their opinions in a new market while insulated from any normal securities law liability in the event that their ratings prove to be inaccurate. In addition, the letter objects to the use of such ratings on a trial basis because, among other things, it would be impossible to evaluate the concerns the ICI and others have about how risk ratings will develop over time as new entities enter the rating business, likely precipitating a "race to the bottom" in the quality of risk ratings. Amy B.R. Lancellotta Associate Counsel Attachments (in .pdf format)

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