INFORMATIONAL

Mutual Fund Performance

NASD Regulation Reminds Members Of Their Responsibilities When Advertising Recent Mutual Fund Performance

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Advertising/Investment Companies
- Internal Audit
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- Mutual Fund
- Registered Representatives
- Senior Management
- Variable Contracts

KEY TOPICS

- Advertising
- Mutual Fund Performance

Executive Summary

Recent unusually strong equity market performance helped some mutual funds, particularly those that are heavily invested in technology stocks, to achieve extraordinary total return figures during the last year (or shorter period). Some members are using advertisements that promote this total return information to attract new investors. NASD Regulation, Inc. (NASD Regulation℠) reminds members of their responsibilities to present fund performance information in a fair and balanced manner and not to create unrealistic investor expectations with regard to future fund performance.

Questions/Further Information

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Background

In 1999, strong equity market performance helped certain mutual funds achieve unusually high total returns. In some cases, equity mutual funds or subaccounts for variable contracts, particularly those with significant investments in technology stocks, achieved total returns exceeding 100 percent for the most recent 12-month period, or even for a shorter period. Some members that distribute or sell these mutual funds or variable contracts are issuing sales material that prominently advertises this unusually high performance. Additionally, certain technology-related funds have been in existence for one year or less, and thus do not have a longer-term track record for investors to consider.

This *Notice* reminds members of their responsibilities to base their communications on principles of fair dealing and good faith and to avoid statements that are exaggerated, unwarranted, or misleading. In particular, this *Notice* cautions members that if they choose to present extraordinary recent fund performance information, they should do so in a manner designed to lessen the possibility that investors will have unreasonable expectations concerning the future performance of these mutual funds.

General Standards

National Association of Securities Dealers, Inc. (NASD®) Rule 2210(d)(1)(A) requires all member communications with the public to be based on principles of fair dealing and good faith, and such communications must provide a sound basis for evaluating the facts in regard to any particular security or securities, type of security, industry discussed, or service offered. Members may not omit any material fact or qualification if the omission would cause the communication to be misleading.

Likewise, Rule 2210(d)(1)(B) prohibits member communications with the public from including exaggerated, unwarranted, or misleading statements or claims. The rule provides that in preparing public communications, members should bear in mind that investments inherently involve the risks of fluctuating prices and the uncertainty of dividends, rates of return, and yield.

The manner in which a member presents performance is equally important. In this regard, Rule 2210(d)(1)(D)(iii) requires members to consider the overall clarity of a communication. The rule notes that disclosures made in an unclear manner can result in a serious misunderstanding of the statement. Similarly, material disclosures relegated to footnotes may not enhance a reader's understanding of the communication.[1]

Application Of General Standards To Mutual Fund Performance Presentations

Taken together, these rules require members to carefully craft their advertisements and other communications, including those intended to promote the sale of mutual funds. In particular, depending on the circumstances, it may be necessary to include information beyond what is required under Securities and Exchange Commission Rule 482 when unusual performance is presented in order for the sales material not to be misleading.

Members should take special care in crafting sales material that presents extraordinary performance. While advertising such performance may increase demand for a fund's shares, it also may lead investors to believe that a fund will continue to achieve the same rates of return in the future. Accordingly, in order to comply with the requirements of Rule 2210(d)(1), members should avoid overemphasizing recent high performance figures or implying that they will recur.

In addition, if a fund's recent performance was the result of its investment focus in an unusually "hot" industry or other factors (such as investing primarily in initial public offerings) that may not continue to exist, we believe members should include prominent, cautionary language in the text of the communication that balances the extraordinary performance presentation. For example, it may be necessary to prominently disclose in such sales material that the advertised performance was attributable to the unusually favorable conditions that are likely not sustainable; to disclose what these conditions were; and to warn that the conditions might not continue to exist and that the advertised performance probably will not be repeated in the future.

Endnote

[1]Securities and Exchange Commission (SEC) Rule 482 under the Securities Act of 1933 and SEC Rule 34b-1 under the Investment Company Act of 1940 also require certain disclosures when mutual fund performance is presented in sales material. In sales material for mutual funds (other than money market funds) that presents performance, the sales material must include a legend disclosing that the performance data quoted represents past performance and that the investment return and principal value will fluctuate, so that an investor's shares, when redeemed, may be worth more or less than their original cost.