MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

June 4, 2008

Via Electronic Mail: rule-comments@sec.gov

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Regulation of Compensation, Fees and Expenses in Public Offerings of Real Estate Investment Trusts and Direct Participation Programs; SR-NASD-2005-114

Dear Ms. Morris:

On May 14, 2008, the Securities and Exchange Commission ("Commission" or "SEC") approved Amendment No. 5 to Rule 2810 filed by the Financial Industry Regulatory Authority ("FINRA"). Securities Exchange Act Release No. 34-57803, 73 Fed. Reg. 27869. The Commission stated in its Federal Register notice that it had conducted a "careful review" of Amendment No. 5 and believed that by "clarifying the standards for determining the fairness and reasonableness of compensation" FINRA's changes would be in the public interest and could go into effect immediately. At the same time, the Commission requested public comment on the issues raised by FINRA's rule change.

Managed Funds Association ("MFA") is pleased to have this opportunity to submit a comment on one aspect of FINRA's changes to Rule 2810 -- the inclusion of futures brokerage trail commissions within the Rule 2810 limits on underwriting compensation.[1] In the Rule 2810 context, futures brokerage trail commissions are a portion of the payments made by public commodity pools to futures commission merchants or introducing brokers for futures execution and account services. The futures firms then allocate the portion of the commission to qualifying individuals. Those individuals must be both SEC-registered representatives affiliated with a registered broker-dealer and associated persons registered under the Commodity Exchange Act ("CEA") who sold investors interests in the pool and, most importantly for purposes of the rule change in question, provide ongoing services to those investors. From 1982-2004, FINRA's

[1] MFA is the voice of the global alternative investment industry. MFA members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media about the global alternative investment industry and the leading advocate for sound business practices and industry growth. MFA is headquartered in Washington, D.C., with an office in New York.

predecessor, National Association of Securities Dealers, Inc., or NASD, considered those brokerage commissions not to be underwriting compensation.[2]

In 2004, FINRA reversed field and announced the view perpetuated in subsequent amendments to Rule 2810, that futures brokerage trail commissions paid by public commodity pools would be deemed to be underwriting compensation subject to the limits imposed by Rule 2810. By this letter, MFA reiterates its request that the Commission reinstate FINRA's 1982 de facto rule excluding futures brokerage trail commissions from the Rule 2810 limits and abrogate FINRA's change to Rule 2810 that now treats such commissions as underwriting compensation. In the alternative, MFA requests that the Commission direct FINRA to reconsider its 2004 decision and resubmit any rule change it adopts in accordance with Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act").

FINRA's 2004 reversal decision was flawed as a matter of law and policy, as MFA explained previously.[3] FINRA failed to articulate a rational, let alone compelling, basis for reversing its 22 year policy and legal interpretation that qualifying futures brokerage trail commissions were not underwriting compensation for purposes of Rule 2810. No change in facts or law precipitated or supported FINRA's action. No evidence of investor harm or abuse was, or could have been, cited by FINRA to justify its reversal. FINRA also did not take into account that, under the CEA, futures brokerage trail commissions are paid with respect to "accounts, agreements and transactions" "involving contracts of sale of a commodity for future delivery" and therefore are subject to the exclusive jurisdiction of the Commodity Futures Trading Commission ("CFTC"). 7 U.S.C.§ 2(a)(1)(A).

Instead, in 2004 FINRA reversed its 1982 determination in order to create what it saw as a level playing field for commodity pools with direct participation programs ("DPPs"), a result, FINRA concluded would not affect the future availability of commodity pools to investors. NASD Notice to Members 04-50 (July 13, 2004), SEA Release 34-50065, 69 Fed. Reg. 45870, 45871 (July 30, 2004). FINRA erred on both counts. FINRA's new policy actually creates an unfair and unlevel playing field for public commodity pools which are already subject to unique regulatory burdens that other DPPs do not face. The available evidence also demonstrates that

[2] "Since 1982, [NASD/FINRA] has had a policy to exclude trail commissions from the 10 percent limitation as it applies to commodity DPPs if: 1) the member is registered with the Commodity Futures Trading Commission as a futures commission merchant; (2) the associated person receiving the trail commissions has passed the Series 31 Futures Managed Funds examination; and (3) the associated person receiving the trail commissions provides ongoing investor relations services to investors." NASD Notice to Members 04-07 (Feb. 2004). Over time, this NASD/FINRA determination was extended to registered associated persons that passed the Series 3 or Series 31 examination.

[3] See MFA letter to the Commission dated October 7, 2004 in response to SEA Release No. 34-50335, MFA letter to the Commission dated August 20, 2004 in response to SEA Release No. 34-50065, and MFA letter to NASD dated March 12, 2004 in response to NASD Notice to Members 04-07. MFA's October 2004 letter urged the Commission to find FINRA's change to Rule 2810 to be invalid procedurally and inconsistent with the substantive Exchange Act standards. That letter attached and incorporated the arguments from our August 2004 and March 2004 letters as well. MFA is attaching each of those letters here and incorporating those arguments again. While the Commission never responded to the October 2004 comment letter in any way, MFA is hopeful the Commission will now do so.

after FINRA's reversal in 2004, the market for public commodity pool offerings in the U.S. has shrunk considerably, despite the public benefits those funds provide.

In this letter, MFA shows 1) the futures brokerage trail commissions issue was never properly approved by the Commission, has never been addressed, let alone resolved, by the Commission and its consideration of that issue now is ripe and timely; 2) futures brokerage trail commissions are covered by the exclusive jurisdiction of the CFTC which supersedes FINRA's authority in this area; and 3) approval of FINRA's inclusion of futures brokerage trail commissions within its underwriting compensation limitation is contrary to the public interest of investors, unfairly discriminates against both pool sponsors and the individuals qualified to receive them and imposes an undue burden on competition.

Procedural Considerations

The text of Amendment No. 5 confirms that the futures brokerage trail commissions issue is still ripe for Commission review and action. FINRA's Amendment No. 5 proposes to amend Rule 2810, in pertinent part, as follows, with the rule change additions provided by FINRA underlined:

> (B) In determining the fairness and reasonableness of organization and offering expenses that are deemed to be in connection with or related to the distribution of the public offering for purposes of subparagraph (A) hereof, the arrangements shall be presumed unfair and unreasonable if:
>
> * * *
>
> [(i)](ii) the total amount of all items of compensation from whatever source, including compensation paid from offering proceeds and in the form of "trail commissions," payable to underwriters, broker/dealers, or affiliates thereof[, which are deemed to be in connection with or related to the distribution of the public offering,] exceeds an amount that equals ten percent of the gross proceeds of the offering (excluding securities purchased through the reinvestment of dividends) [currently effective compensation guidelines for direct participation programs published by the Association; …

Amendment No. 5, pages 16-17. For purposes of determining whether a public commodity pool offering contemplates fair and reasonable organization and offering expenses, Amendment No. 5 adds, by the underlined language, "compensation … in the form of 'trail commissions'" to the 10% limitation. The proposed rule change described in and made by Amendment No. 5 therefore raises explicitly, and from FINRA's own perspective, in a duplicative procedural step, the futures brokerage trail commissions issue, making it appropriate for the Commission to address the issues raised at this time.

FINRA may try to block Commission consideration of the merits of the futures brokerage trail commissions issue, as it has in the past. Just last month, FINRA insisted that the Commission should disregard as procedurally out of time a thoughtful comment letter filed by R.J. O'Brien Fund Management, LLC ("R.J. O'Brien") on this issue on April 28, 2008. R.J. O'Brien's letter was filed after FINRA Amendment No. 4 to Rule 2810 which indicated that the words "including

… trail commissions" were technically part of the rule change. See SEA Release, 34-57199, 73 Fed. Reg. 5885 (Jan. 31, 2008); FINRA Amendment No. 4 (Jan. 2, 2008). The "trail commissions" language had been included in prior iterations of Rule 2810. The Commission, however, has never addressed the substance of the trail commissions issue. The R.J. O'Brien letter assumed therefore that the issue was still open and its comments addressing those brokerage commissions payments were timely and appropriate. The Commission should have responded to the points raised in that letter.

Yet FINRA claimed the issues raised by R.J. O'Brien "were addressed by the SEC in an approval order issued in a prior rulemaking proceeding. See SEA Release No. [34-]50335 (Sept. 9, 2004) ….". 73 Fed. Reg. 27869, 27872 n.27 (May 14, 2008). SEA Release No. 34-50335, however, does not contain any Commission approval or articulated policy basis for approving FINRA's 2004 policy reversal. 69 Fed. Reg. 55855 (Sept. 16, 2004). To the contrary, the Commission in 2004 recited that FINRA had "designated the proposed rule change as constituting a stated policy, practice or interpretation with respect to the meaning, administration or enforcement of an existing rule of NASD under Section 19(b)(3)(A)(i) of the Act and Rule 19b-4(f)(1) thereunder, which renders the proposal effective upon receipt of this filing by the Commission." *Id*. Then, the Commission wrote: "The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons." *Id*.

The Commission described FINRA's rule change in September 2004 as "proposed" because it was not Commission "approved" as FINRA now contends. As that Commission release confirms, the rule change was declared effective by operation of law based on FINRA's erroneous assertion that it was a mere interpretation, but never received Commission approval. SEA Release 34-50335, 69 Fed. Reg. 55855 (Sept. 16, 2004). For that reason, in 2004, MFA submitted comments to the Commission in October 2004 on the proposed rule change. See note 3 *supra*. MFA raised objections to both the procedures FINRA followed because it submitted a substantive rule change in the guise of an interpretation and the substance of FINRA's new position. To date, the Commission has never addressed any issues raised by those comments. In MFA's view, the Commission now should consider and act upon the legal and policy issues raised by FINRA's substantial rule change concerning payments in the form of futures brokerage trail commissions as embodied in Rule 2810.[4]

[4] The failure of the Commission to respond to the filed public comments or explain the basis for any determination on futures brokerage trail commissions would be grounds for invalidating the Commission's actions in relation to FINRA's changes to Rule 2810. See Board of Trade of the City of Chicago v. SEC, 883 F.2d 525, 536 (7th Cir. 1989) citing SEC v. Chenery Corp., 318 U.S. 80, 88 (1943).

Jurisdictional Issues

The CFTC has exclusive jurisdiction over futures brokerage trail commissions. 7 U.S.C. § 2(a)(1)(A). Neither FINRA nor the Commission has authority to transform those commissions into underwriting compensation. As FINRA's 1982 position confirmed, futures brokerage trail commissions were not underwriting compensation and should not be subject to any limits under Rule 2810. For twenty-two years after FINRA adopted its 1982 position, it respected the CFTC's exclusive jurisdiction and its own corresponding jurisdictional limits. FINRA's 2004 reversal decision and subsequent rule changes, however, contravene CFTC exclusive jurisdiction and should be abrogated, with Rule 2810 returned to its 1982 status in this area.

Futures Brokerage Trail Commissions.

Under the CEA, futures brokerage firms, called futures commission merchants ("FCMs") or introducing brokers ("IBs"), must be registered with the CFTC and become members of the National Futures Association ("NFA"). 7 U.S.C. §§ 1a(20), 1a(23), 6d(a), and 21(m); CFTC Rules 3.2, 3.4 and 170.15(b); NFA Bylaw 1101. Futures brokerage commissions are fees for services paid by customers to FCMs and IBs and are regulated by the CFTC as well as NFA to promote fair dealing and to prevent fraud. These fees are the subject of an agreement reached between a futures customer and the FCM or IB. The services covered by the brokerage commissions often include the acceptance and execution of futures customer orders and the provision of ongoing advice and services relating to trading in, and the operations of, the futures markets. The FCMs and IBs may share portions of these commissions with their employees, called associated persons ("APs"), if they are registered APs with the CFTC and members of NFA. 7 U.S.C. §§ 6k(1) and 21(m); CFTC Rules 3.2, 3.4, and 3.12; NFA Rule 1003.3. If a customer opens an individual futures trading account with an FCM, for example, as a result of sales efforts of the FCM's AP, and that AP would perform continuing services to the customer, the FCM may share its brokerage commissions paid by that customer with the AP due to the continuing services the AP provides to the customer.

Some FCM customers are commodity funds or pools. These collective investment vehicles afford investors the ability to enjoy the benefits of professional management while participating in futures markets through a structure where the investor's risk typically is limited as a limited partner or otherwise. The operators of a commodity pool ("CPOs") and futures trading advisors ("CTAs") who make trading decisions for the pool also are CFTC registered and regulated, and must be NFA members as well. 7 U.S.C. §§ 1a(5), 1a(6), 6m(1) and 21(m); CFTC Rules 3.2, 3.4; NFA Bylaw 1101. For many years, publicly offered commodity pools were popular investment vehicles that allowed non-accredited investors to diversify their investment portfolios and participate in futures markets through the services of professional trading advisors with transparent and extensive track records. See *Money Under Management in Managed Funds*, Barclay's Hedge, (showing the growth in all managed funds since 1980), available at http://www.barclayhedge.com/research/indices/cta/Money_Under_Management.html (last accessed June 4, 2008).

Like other public securities offerings, the offer and sale of interests in a commodity pool are subject to the Securities Act of 1933. No one questions the authority of FINRA to regulate the underwriting compensation for public offerings of securities. But no one has ever maintained that futures brokerage commissions constitute securities underwriting compensation.

For decades, public commodity pool offerings regularly disclosed that FCMs would allocate a portion of the futures brokerage commissions received from the commodity pool to qualifying APs. This allocation would not increase in any way the amount of futures brokerage commissions a pool would pay. Instead, the monies paid to qualifying APs would come out of the FCM's futures brokerage commissions and would be allocated to APs who sold interests in public commodity pools and whose sponsoring firms agreed to and provided services to investors so as to facilitate the investors' understanding of the intricacies of futures markets, which the U.S. Supreme Court and the Congress have described as "volatile and esoteric." *Merrill Lynch vs. Curran*, 456 U.S. 353, 356 (1982). This practice became known as futures brokerage trail commissions.

Starting in 1982, and continuing until 2004, FINRA, through its predecessor NASD, determined under certain criteria that were applied in the course of reviewing the sales compensation terms pertaining to publicly offered commodity pools and under which futures brokerage commissions could be allocated to qualifying APs without counting as underwriting compensation. "Since 1982, [NASD/FINRA] has had a policy to exclude trail commissions from the 10 percent limitation as it applies to commodity DPPs if: 1) the member is registered with the Commodity Futures Trading Commission as a futures commission merchant; (2) the associated person receiving the trail commissions has passed the Series 31 Futures Managed Funds examination; and (3) the associated person receiving the trail commissions provides ongoing investor relations services to investors." NASD Notice to Members 04-07 (Feb. 2004). (Subsequently, that determination was extended to registered IBs and APs who passed the Series 3 examination.)

The services provided by APs that may receive futures brokerage trail commissions require knowledge of both commodity pools and the futures markets. These services, as generally described in the prospectuses of publicly offered commodity pools and historically required through NASD review and comment letters, are: (a) responding to inquiries from investors about the value of units; (b) providing information and responding to inquiries about the futures and forward markets and the fund's trading in those markets; (c) responding to limited partners' inquiries about monthly statements and annual reports and tax information provided to them; (d) providing information to investors about redemption rights and procedures; (e) assisting investors in redeeming units; and (f) providing other services requested from time to time by investors. These services exceed what may be provided in the context of mutual funds, exchange-traded funds, and exchange-traded notes.

FINRA applied its qualification criteria excluding futures brokerage trail commissions from underwriting compensation to hundreds of commodity pool offerings from 1982 until 2004. Without citing any abuses, FINRA reversed its policy in 2004 and declared futures brokerage commissions allocated by FCMs in accordance with FINRA's 1982 determination would thereafter be considered to be underwriting compensation. NASD Notice to Members 04-50 (July 13, 2004); SEA Release 34-50065, 69 Fed. Reg. 45870 (July 30, 2004); SEA Release 34-50335, 60 Fed. Reg. 55855 (Sept. 16, 2004). As a consequence, the futures brokerage trail commissions now are counted toward the 10% limit on underwriting compensation under FINRA Rule 2810.

Futures Brokerage Trail Commissions are Subject to CFTC Exclusive Jurisdiction.

As the Commission well knows, Congress provided in the CEA that the CFTC "shall have exclusive jurisdiction … with respect to accounts, agreements … and transactions involving contracts of sale of a commodity for future delivery," also known as futures contracts. 7 U.S.C. § 2(a)(1)(A). Futures brokerage commissions are paid as a result of a commodity pool's agreement with its FCM or FCMs for transactions involving futures trading activity. Futures brokerage trail commissions are paid by the FCMs to qualifying APs again as a result of agreements between the pool's FCM and the AP's sponsoring FCM or IB firm which surely "involve" futures trading activity.

Based on the plain meaning of the statute's terms, futures brokerage trail commissions fit comfortably within the CEA's grant of exclusive jurisdiction. Courts have made clear that matters committed to the CFTC's exclusive regulatory jurisdiction are not subject to any regulation by other federal or state agencies, even if those agencies would otherwise have been able to assert jurisdiction. See *CME vs. SEC* (IPs case), 883 F.2d 537 (7th Cir. 1989) and *Board of Trade of the City of Chicago vs. SEC* (GNMA Options case), 677 F.2d 1137 (7th Cir. 1982). As FINRA's authority is derived from the Exchange Act, and that statute has been superseded by Congress for those matters subject to CFTC exclusive jurisdiction, FINRA has no authority to treat as underwriting compensation any portion of the futures brokerage commission paid to an FCM and qualifying APs.

FINRA may claim Section 4m(2) of the CEA, as enacted in 1982, supports its effort to override CFTC exclusive jurisdiction. 7 U.S.C. § 6m(2). Section 4m(2) provides: "Nothing in this Act shall relieve any person of any obligation or duty … arising under the Securities Act of 1933 or the Securities Exchange Act of 1934 governing the issuance, offer, purchase, or sale of securities of a commodity pool, or of persons engaged in transactions with respect to such securities, or reporting by a commodity pool." Under these provisions, FINRA might try to argue it has jurisdiction because futures brokerage trail commissions implicate the duty of commodity pool sponsors not to pay more than 10% in underwriting compensation in connection with the offer of securities of a commodity pool. But FINRA's 1982 decision <u>not</u> to treat qualifying futures brokerage trail commissions as underwriting compensation effectively blocks FINRA from logically making that claim. At the same time Congress was enacting Section 4m(2), FINRA had determined that these futures brokerage commission payments were not underwriting compensation. And FINRA continued that legal interpretation for over 20 years. Surely Congress could not have intended FINRA to regulate as underwriting compensation futures brokerage commissions that FINRA stated publicly were not underwriting compensation. Section 4m(2) offers little help to FINRA on this issue.

<u>FINRA's 1982 Trail Commission Determination Satisfied the Exchange Act's Standards, Its 2004 Reversal Does Not.</u>

FINRA rules must generally satisfy the public interest as well as avoid unfair discrimination and not burden competition unless necessary to achieve the Exchange Act's objectives. Exchange Act, Section 15A(b)(6). FINRA's decision to treat futures brokerage trail commissions as underwriting compensation subject to the 10% limit replaced a policy that met the statute's requirements with one that does not. Even if the Commission believes that FINRA has jurisdiction over futures brokerage trail commissions, the Commission should abrogate FINRA's 2004 reversal of its 1982 determination or direct FINRA to reconsider its 2004 decision. Indeed, like the Commission and other agencies, FINRA bears a heavy burden when it reverses regulatory course and rescinds one of its rules. See *Motor Vehicle Manufacturers v. State Farm*, 463 U.S. 29, 42 (1983) ("an agency changing its course by rescinding a rule is obligated to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance").

Public Interest Considerations.

Since their inception decades ago, publicly offered commodity pools have had no history of abuses; and, more specifically, there has been no history of abuses connected with the payment of futures brokerage trail commissions. Prior to FINRA's reversal of its 1982 determination, public commodity pools were becoming increasingly popular, as interest in the benefits provided by managed futures and other alternative investments has grown among the retail investing public. In response to that increased interest and the resulting competitive pressures prior to the FINRA reversal, the number of public commodity pools in the United States had increased and the fees paid by such pools had decreased. In particular, advisory and brokerage fees paid by public commodity pools were substantially reduced, presumably as the result of competition, which benefit investors.

When publishing its reversal decision in 2004, FINRA noted: "staff believes that notwithstanding a limit on the level of underwriting compensation, firms and registered representatives will continue to offer and recommend commodity pool DPPs." NASD Notice to Members 04-50 (July 13, 2004); SEA Release 34-50065, 69 Fed. Reg. 45870, 45871 (July 30, 2004). Available data suggest that, contrary to FINRA's stated expectation, its policy reversal has resulted in a sharp decline in the number of public commodity pools. The annual average number of registered public commodity pool offerings from 1997-2003 was over 12. From 2005-2007, that annual average fell to 4.[5]

As these data show, since 2004, public investors have faced dwindling opportunities to diversify their investment risk exposures by participating in commodity futures markets through professionally managed commodity pool offerings. As a result, the benefits of commodity pools as investment alternatives are less accessible to the investing public.

Last, Congress has identified price discovery as one of the main public interest functions of futures trading. 7 U.S.C. § 5(a). In order for futures markets to perform this function, both speculators and hedgers must use the markets. Public commodity pools provide a significant source of trading capital (both long and short), provide liquidity to the futures markets, and facilitate transparent and balanced price discovery and efficient risk transference. FINRA's new

[5] These data exclude exchange traded funds. We also have not included pool offerings for the year 2004, in our annual figures although the number of offerings in 2004 would have substantially increased the annual average number of public commodity pool registrations for the period immediately before FINRA's new trail commission rules went into effect. Some may claim that the effective date and grandfathering under the prior policy might have skewed the data on the impact of FINRA's new policy, so we disregarded those data.

policy on trail commissions could lead to reduced liquidity and volume on U.S. exchanges, and consequently have an adverse effect on the price discovery function performed by those markets.

Public Benefits of Commodity Pools.

Commodity pools are generally acknowledged by regulators and the financial press as offering the safest and least expensive mechanism for retail investors to engage in futures trading for investment and/or portfolio diversification purposes through the inclusion of a historically non-correlated investment to a traditional stock and bond portfolio. Typically, a commodity pool raises capital through the sale of pool interests, such as shares or units of limited partnership, through either a public offering or a private placement of securities. The commodity pool's capital is thereafter invested in Treasury bills and/or maintained in cash or cash equivalents, which is then used for margin for the pool's trading.

The principal acknowledged benefits provided by public commodity pools include:

- limited liability for investors;
- access to professional management at a greatly reduced minimum investment amount;
- transparency of investment activities (e.g. independently determined daily settlement prices) resulting in daily net asset valuation;
- monthly or even daily investment liquidity through redemption rights;
- the ability to take short or long positions in futures and options contracts on energy products, industrial goods, metals, agricultural and "soft" commodities, stock indices, and interest rates as well as in futures, forwards, and options contracts on global currencies; and
- an environment of strong, multi-agency regulatory oversight through firm and associated person registration requirements, disclosure requirements, suitability standards, and solicitation restrictions.

Alternative means of accessing the futures and forwards markets, such as individual managed accounts and private placement offerings, often fail to provide similar benefits to investors, and may result in unlimited liability for investors, restricted access to professional management, less regulatory oversight and higher fees.

Public commodity pools are highly regulated by the CFTC, NFA, Commission, and state blue sky regulators and provide limited liability for investors, as well as containing higher suitability standards and solicitation restrictions than other commodity-related investments. For example, individual managed futures accounts are subject to CFTC/NFA regulation, but are not subject to SEC, FINRA or state securities law jurisdiction and have unlimited liability, typically higher fees, restricted access to advisors and less regulatory oversight. And, of course, individually managed futures accounts may have futures brokerage trail commissions.

Moreover, public commodity pools provide retail investors with access to many of the most successful CTAs. This access would be severely curtailed for public investors if public commodity pools were not available, due to the large minimum account size requirements of many of those CTAs and the higher suitability requirements and capital net worth obligations for investors in privately offered commodity pools. In addition, portfolio diversification is a basic tenet of modern investment theory. Commodity pools generally provide investors with the potential to enhance portfolio returns and reduce overall portfolio volatility by diversifying beyond traditional investments, such as stocks and bonds, into historically non-correlated managed futures. Consequently, the diversification benefits of managed futures have made commodity pools an important element of an individual investor's overall portfolio diversification strategy. In fact, most pools offered today are sold as a portfolio diversification strategy.

If FINRA's 2004 reversal decision is undisturbed and as a result, the number of publicly offered commodity pools is severely reduced as we have seen in the last three years, retail investors will be denied access to the only affordable futures-based product currently available in a limited liability structure (i.e., a limited partnership, limited liability company or other limited liability entity) and to one of the only alternative investment products available to diversify a traditional stock and bond portfolio. That can not serve the public's interests.

Trail Commissions Are Fair.

Futures brokerage trail commissions are service fees paid for commodity-related services. Trail commissions developed from and are consistent with practices of FCMs with respect to individual customer futures accounts. Associated persons of FCMs who service those futures accounts typically share in the futures brokerage commissions generated by the accounts. In fact, the qualification requirements applicable to APs receiving futures brokerage trail commissions from pools are similar to those applicable to APs who limit their activities to individual customer futures accounts.

APs who received futures brokerage trail commissions under the 1982 policy must qualify by registering as APs under the CEA and must first pass either the Series 3 or the Series 31 examination which requires a demonstrated competency in commodity-related matters. See NASD Notice to Members 04-07 (Feb. 2004). As registrants under the CEA, these individuals are subject to sanctions under the CEA and related rules (including those of the CFTC and NFA). 7 U.S.C. § 6k(1); CFTC Rule 3.12; NFA Rules 3-14 and 1003.3. APs are also subject to periodic ethics training requirements. 7 U.S.C. § 6p(b).

As noted above, commodity pools are often sold as a portfolio diversification strategy. Consequently, APs may be required to monitor the traditional elements of an investor's portfolio as well as the futures component. CPOs retain selling agents with registered representatives who are also registered as APs of FCMs and IBs in order to perform those service functions. If APs did not provide these services to pool investors, the pool's CPO would have to incur additional expenses to develop an alternative mechanism for providing such services to pool investors.

Commodity Pools are Different.

FINRA's primary stated reason for changing its policy on futures brokerage trail commissions was to treat commodity pools the same way as "other DPPs." NASD Notice to Members 04-50 (July 13, 2004); SEA Release 34-50065, 69 Fed. Reg. 45870, 45871 (July 30, 2004). Publicly offered commodity pools should not be treated in the same manner as other DPPs because public commodity pools are materially different. Among the distinguishing features of commodity pools are the breadth of futures-related interests traded, the rapid turnover of a managed futures portfolio's holdings, the frequency of daily net asset valuations and monthly investment liquidity, and the continuous nature of the offering.

Publicly offered commodity pools also differ from other DPPs subject to NASD Rule 2810 in significant structural and operational ways. For example, real estate and oil and gas partnerships typically purchase properties or other assets at the outset of operations and then hold those properties or assets until the termination of the partnership. These DPPs invest in relatively illiquid assets, whereas commodity pools typically invest in only the most liquid types of instruments. Although these DPP programs provide annual financial statements, they often do not provide daily net asset values and typically do not permit regular redemptions. Commodity pools, on the other hand, engage in daily trading of multiple futures contracts on multiple markets. Commodity pools are required to provide daily net asset values. Commodity pools provide redemption opportunities on at least a monthly basis and liquidity restrictions require that proper written notice of redemption be provided to the pool operator. In addition, most commodity pools engage in continuous offerings of interests, at least until such time as a maximum level of assets is reached.

Unlike other DPPs subject to NASD Rule 2810, suitability standards require that each investor in publicly offered commodity pools completes a subscription agreement wherein the investor represents that the investment is suitable and that the investor agrees to terms such as risk factors, conflicts and liquidity restrictions. CFTC reporting requirements require that commodity pools send monthly to each investor current financial statements for the pool as well as a narrative describing the prior month's activity and the client's individual investment valuation. Publicly offered commodity pools are required to file monthly Prospectus Supplements on Form 424(b)(3) with this information.

In addition, commodity pools are subject to other special regulatory requirements, which exceed considerably those that apply to other limited partnership programs. Those products, such as real estate or oil and gas partnerships, are not subject to a separate federal regulatory framework. Commodity pools and commodity professionals, as noted above, are subject to regulation by the CFTC and NFA under the CEA, and at the operational level, the CFTC's regulation is supposed to be exclusive. Those selling commodity pools and providing services to investors therein are required to have certain types of training and a minimum level of competency in order to receive trail commissions, while no similar standard exists with respect to other DPPs.

Many states substantively review prospectuses for public pools and impose investor suitability requirements (income and/or net worth -- exclusive of home, furnishings and automobiles) on public pool participants. In fact, many states have adopted the North American Securities Administrators Association Guidelines for Registration of Commodity Pool Programs, which set forth requirements for and limitations on the operation of commodity pools. Limitations include maximum fees to be charged. The current guidelines specifically permit payment of futures brokerage trail commissions. In contrast, states do not review the prospectuses of registered investment companies and almost anyone can purchase shares in them.

Because commodity pools are structured as limited partnerships for income tax purposes, investors receive a Form K-1 for annual income tax reporting compared with the more familiar Form 1099 that is received for mutual funds or stock investments. A commodity pool's activities make the tax attributes more complex than those reported in Form 1099. For example, certain contracts that trade on U.S. exchanges are characterized as Section 1256 contracts and treated as 60% long-term and 40% short-term capital gain or loss, where other contracts are short-term. Other tax items need to be reflected in specific tax forms such as Schedule E. These and other tax attributes of the pools make it more difficult for investors and their accountants to understand these investments. Investors often ask APs questions about these tax complexities. As a result of these differences, investors require more and different information than investors in other DPPs as well as additional time with APs to administer these processes.

FINRA ignored these unique features of public commodity pools and adopted a rule change which discriminates against these offerings by trying to homogenize them with other DPPs. But see Exchange Act, Section 15A(b)(6) (requiring that FINRA's rules promote just and equitable principles of trade and not discriminate). Put simply, lumping futures brokerage trail commissions, paid by an already operating commodity pool, into underwriting compensation in effect grants other DPPs a serious competitive advantage compared to commodity pools. The other DPPs, which already enjoy an advantage in lower regulatory expenses (no CFTC or NFA regulation or review of offering materials, for example), may pay 10% in true underwriting compensation to those that sell interests in their offerings. If a commodity pool pays the same 10% compensation, under the change to Rule 2810, the pool may not allocate any monies from its brokerage commission to an AP that is providing ongoing services for investors in that pool. APs would be forced to provide these services without compensation once a pool is operational, services for which they would surely be compensated if the investors opened individual managed accounts, rather than make a pooled investment. As the data cited earlier shows, the decline in the number and size of public commodity pool offerings supports a finding that FINRA's rule change has discriminated against public commodity pools and inflicted real competitive harm.

* * * * *

(Continued on next page)

Conclusion:

MFA appreciates the opportunity to comment on the rule changes to FINRA Rule 2810. We support the Commission's efforts to protect investors and to promote competitive securities markets. In our view, however, FINRA has exceeded its legal authority by attempting to regulate and limit futures brokerage trail commissions. And, even if FINRA had authority to treat those brokerage commissions for regulated service providers as underwriting compensation, its 2810 rule changes are not sound public policy and should be abrogated by the Commission under the Exchange Act, while reinstating FINRA's trail commission determination from 1982. In the alternative, the Commission should direct FINRA to reconsider its changes to Rule 2810 and resubmit its rules under Section 19(b)(1) of the Exchange Act for full Commission consideration.

Please feel free to call me at (202) 367-1140 if you have any questions or comments. We would be pleased to meet with Commissioners or Staff to discuss our comments.

Sincerely,

Richard H. Baker
President and Chief Executive Officer

Enclosures

CC: The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Kathleen L. Casey, Commissioner
Dr. Erik Sirri, Director
Division of Trading and Markets

The Hon. Walter Lukken, Chairman
The Hon. Michael Dunn, Commissioner
The Hon. Jill E. Sommers, Commissioner
The Hon. Bart Chilton, Commissioner

MANAGED FUNDS ASSOCIATION

August 20, 2004

By E-Mail: rule-comments@sec.gov

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609
Attention: Mr. Jonathan G. Katz, Secretary

Re: Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to the Treatment of Commodity Pool Trail Commissions; Release No. 34-50065; File No. SR-NASD-2004-108 (the "Release")

Ladies and Gentlemen:

Managed Funds Association ("MFA") welcomes the opportunity to comment on the Release concerning the NASD's proposal to rescind its long-standing policy with respect to compensation paid to CFTC-regulated brokers who place interests in a publicly offered commodity pool and provide ongoing services to investors in the pool ("trail commissions"). We hope our comments prove helpful to the Commission.

Under the NASD's policy, trail commissions have not been deemed to be sales compensation, subject to the limitations in NASD Rule 2810, for over 20 years. MFA believes that the NASD's policy should be codified rather than rescinded, to permit the continued efficient operation of commodity pools, including provision of important services to commodity pool investors. The reasons for MFA's belief were set forth in its letter dated March 12, 2004 on Notice to Members 04-07 (the "MFA Letter"), a copy of which is attached As we discuss below, moreover, MFA believes that (i) the NASD's proposal to rescind its policy constitutes a significant rule change that should have been accorded the required notice and comment period prior to its effectiveness under Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Exchange Act"), and (ii) the Commission should abrogate the effectiveness of the proposal or permit the NASD to withdraw and revise it because it is inconsistent with the provisions of the Exchange Act applicable to the NASD.

MFA is the only US-based membership organization dedicated to serving the needs of professionals who manage futures funds, hedge funds, and funds of funds. Our over 700 members manage a significant portion of the estimated $750 billion invested in these alternative investment vehicles. Among the MFA membership are commodity pool operators

("CPOs"), commodity trading advisors ("CTAs") and futures commission merchants ("FCMs"), as well as NASD-member broker-dealers, who provide their respective services in connection with a significant portion of the estimated $87 billion invested in managed futures products, including publicly offered commodity pools. Accordingly, MFA's members have a keen interest in the proposals set forth in the Release and in the NASD's policy on trail commissions.

I. Background.

As noted above, the NASD policy, under which commodity pool trail commissions have been excluded from the limitations in NASD Rule 2810, has been in place for over 20 years. The exclusion was reconfirmed in the NASD approval process of the underwriting arrangements for every public commodity pool registered under the Securities Act of 1933 during that time. The sponsor of the pool was required to represent that (i) trail commissions would be paid only to FCMs or introducing brokers ("IBs") registered with the Commodity Futures Trading Commission ("CFTC"), (ii) FCMs or IBs would share trail commissions only with their associated persons who were registered with the CFTC, having passed the Series 3 or 31 Exam and (iii) associated persons receiving trail commissions would provide ongoing services to investors in the pool.

In the fall of 2003, NASD staff began questioning the exclusion for trail commissions in its review of several new commodity pool filings. Industry participants met with NASD staff to provide them information concerning the operation of commodity pools and the commercial need for payment of trail commissions. On March 12, 2004 in Notice to Members 04-07, the NASD proposed rescinding its exclusion from Rule 2810 for commodity pool trail commissions and requested comments from interested persons. As stated in the Release, the NASD received 26 comment letters, almost all of them opposed to the rescission. Letters were received from NASD members, CPOs and CTAs, industry groups, regulators and self-regulators and the Association of the Bar of the City of New York. Nonetheless, on July 13, 2004, the NASD issued its Notice to Members 04-50 (the "Notice"), which rescinded the NASD policy on trail commissions, effective immediately.

The Notice did not provide a detailed summary or analysis of the arguments and issues raised in the comment letters opposed to the rescission. The Notice baldly stated that the reasons underlying the trail commissions policy "no longer apply today", and that no evidence was presented that "commodity pool DPP investors receive a significantly higher level of service than investors in other DPPs." In fact, that simply was not true. Commodity pool investments are more complex and less widely understood than stocks, bonds, real estate or physical commodities like oil and gas. As a result, investors in commodity pools receive a significantly higher level of services than investors in other DPPs. Provision of those services, moreover, is a commodity-related activity, as it has been for over 20 years. These points were amply demonstrated in comment letters on Notice to Members 04-07, including the MFA Letter.

In the short run, as a result of this precipitous action of the NASD, registrations of at least two public commodity pools pending with the NASD have been disrupted. These offerings will have to be altered or withdrawn. The sponsors of these offerings have expended substantial amounts to prepare and file documents which complied with NASD rules in effect before July 13, 2004, but no longer comply as a result of the rescission in the Notice.

In the longer run, the action of the NASD will impede the growth and operation of an industry that provides public investors with alternative investment opportunities that are not available elsewhere. A description of the industry, the benefits to the public of commodity pools and the arguments against rescission of the policy on trail commissions appear in the attached MFA Letter.

II. Procedures to Implement Rule Changes.

The NASD's 20-year policy of excluding trail commissions from the limitations in Rule 2810 amounted to a de facto rule. Therefore, the proposal to rescind the policy on trail commissions should be regarded as a proposed rule change, rather than a change in interpretation of an existing rule. The NASD should have filed its proposal as a proposed rule change under Section 19(b)(1) of the Exchange Act without reliance on the exception from the notice-and-comment period that permits immediate effectiveness for changed interpretations of an existing rule. Had the NASD followed this procedure, the proposal would have been published in the Federal Register, comments would have been solicited and the Commission would have been able to review and evaluate those comments, all before the proposal became effective - in accord with the Congressional intent underlying the Commission's oversight of the NASD.

As the Commission is aware, the NASD is generally required to file proposed rule changes with the Commission and obtain Commission approval before the rule changes can become effective. An exception to this general requirement in Exchange Act Section 19(b)(3)(A) and Rule 19b-4(f)(1) permits a self-regulatory organization ("SRO") to declare a rule change effective upon filing with the SEC if the SRO designates the rule change to be a "stated policy, practice or interpretation with respect to the meaning, administration, or enforcement of an existing rule" of the SRO. Exchange Act Rule 19b-4(b) defines the term "stated policy, practice or interpretation" to mean, in pertinent part, any statement made generally available to the membership of, to all participants in, or to persons having or seeking access to the facilities of the SRO that establishes or changes any standard, limit, or guideline with respect to (i) the rights, obligations or privileges of such persons or (ii) the meaning, administration or enforcement of an existing rule. Rule 19b-4 goes on to state that a stated policy, practice or interpretation shall be deemed a rule change unless (i) it may be reasonably and fairly implied by an existing rule or (ii) it is concerned solely with the administration of the SRO.

The NASD's policy of excluding trail commissions from the application of Rule 2810, although not literally a written provision included in Rule 2810, has operated as such a written exclusion would have operated for over 20 years. The NASD has uniformly applied the exclusion as if it were a rule during all that time. The exclusion has been applied in written form through the means of comment letters on specific underwriting arrangements issued by NASD staff. The entire commodity pool industry has relied on the exclusion in offering and operating its commodity pools. Therefore, the exclusion is part of Rule 2810. The Notice purports to change the rule in a manner that cannot be reasonably and fairly implied by the existing rule. In fact, the Notice rescinds the rule entirely and, in effect, imposes a prohibition on payment of trail commissions exceeding the limits in Rule 2810. As the U.S. Court of Appeals for the Tenth Circuit noted in *General Bond & Share Co. v. SEC*, 39 F.3d 1451 at 1460 (1994). "When a prohibition sets a new standard for its members, …the NASD is required by statute to submit such a change to SEC prior to enforcing it." *See also, Matter of Bloomberg L.P.,* Securities Exchange Act Release No. 49076 (January 14, 2004) (New York Stock Exchange interpretations and requirements built into contracts were rules and, in the absence of Commission approval, were invalid and unenforceable).

As discussed above, the NASD's policy on trail commissions has been and is part of Rule 2810. Therefore, to impose a prohibition on the payment of certain trail commissions, the NASD was obliged to file its proposed rule change (i.e., rescission of its policy) with the SEC for notice and comment *before* declaring the rule change effective.

III. Exchange Act Requirements for SEC Action.

Regardless of whether it concludes the NASD could not, as we believe, lawfully make its new policy effective upon filing, the Commission should exercise its power under Exchange Act Section 19(b)(3)(A) to summarily abrogate the NASD policy and require that it be refiled under Section 19(b)(1). The standard for that action, as the Commission knows, is broad and discretionary. The Commission may exercise that power whenever it appears necessary or appropriate in the public interest, for the protection of investors or otherwise furthers the purposes of the Exchange Act.

The Commission should exercise its summary abrogation power, MFA respectfully suggests, in cases where an NASD action raises serious questions of legality under the Exchange Act standards applicable to the NASD. MFA believes this is such a case, as discussed below.

A. Section 15A(b)(6).

As the Commission knows, Exchange Act Section 15A(b)(6) requires that NASD rules not be "designed to permit unfair discrimination between customers, issuers, brokers, or dealers . . . ." The new NASD policy discriminates between an NASD member's customers as well as its associated persons who service the customers' accounts, discriminating without any reasonable basis between cases where the customer invests in commodity managed accounts — where trail commissions are unlimited — and cases in which customers invest in a publicly offered commodity pool — where trail commission are limited. In the case of both pools and managed accounts, an FCM will execute and clear futures contracts, an IB may introduce clients and a CPO and/or CTA will manage the account. In the case of the public commodity pool investment, however, the FCM or IB will be able to compensate its associated persons for providing ongoing services to investors only within the limitations of Rule 2810. Similarly, if the CPO/CTA pays the FCM or IB, the CPO/CTA will be limited by Rule 2810 with respect to the public pool. These limitations are not applicable to individual commodity managed accounts. If the discrimination is not in fact necessary or appropriate to address a valid regulatory purpose, and in the case of this proposed rule change it is not, it is inconsistent with the requirements of Section 15A(b)(6).

Section 15A(b)(6) further requires that NASD rules not be designed to "regulate by virtue of any authority conferred by [the Exchange Act] matters not related to the purposes of [the Exchange Act] or the administration of the [NASD]." In this case, the NASD's proposed rule change is designed and will have the effect of regulating the activities of FCMs, IBs, CPOs and CTAs and their associated persons, which activities are subject to the Commodity Exchange Act and Commodity Futures Trading Commission jurisdiction. These matters are not related to the purposes of the Exchange Act.

B. Section 15A(b)(9).

Section 15A(b)(9) requires that NASD rules "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act]." As a result of the immediate effectiveness of the proposed rule change, the rule change has placed a burden on competition by requiring costly and time consuming changes to the offering arrangements of the pools that were in registration, but not yet approved, when the proposed rule change was published.

Another anticompetitive impact of the rule change is the barrier to entry to the publicly offered pool industry that it creates for new or small CPOs. These CPOs will be less able to afford to increase staff to provide the services that otherwise could be contracted out to brokers compensated by means of trail commissions.

C. Result.

As demonstrated above, the proposed rule change is inconsistent with the provisions of the Exchange Act applicable to the NASD because it discriminates unfairly among customers and brokers, purports to regulate matters not related to the purposes of the Exchange Act and imposes unnecessary and inappropriate burdens on competition.

IV. Conclusion.

As discussed above, the NASD's proposed rule change is a significant change to a well-established business practice of an entire industry that by law should have been submitted to the SEC for notice and comment before effectiveness. Moreover, the proposed rule change is inconsistent with the provisions of the Exchange Act applicable to the NASD. Therefore, the SEC should abrogate the proposal or permit the NASD to withdraw and revise it in order to cure its flaws and, if a proposal is resubmitted, require that the public be afforded a formal notice and a comment period before approval or disapproval of the proposed rule.

We hope our comments are helpful to the Commission and its staff. Please call me at (202) 367-1140 if we can provide additional information.

Respectfully submitted,

John G. Gaine
President

Attachment: MFA's letter dated March 12, 2004

cc(w/att.): The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Harvey J. Goldschmid, Commissioner
The Hon. Roel C. Campos, Commissioner
Annette L. Nazareth, Esq., Director
Division of Market Regulation
Robert L. D. Colby, Esq., Deputy Director
Division of Market Regulation
Elizabeth King, Associate Director
Division of Market Regulation
Giovanni P. Prezioso, Esq., General Counsel

NASD

Mary L. Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, NASD
Barbara Z. Sweeney, Senior Vice President and Corporate Secretary NASD
Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, NASD
Joseph E. Price,Vice President, Corporate Financing, NASD
Gary Goldsholle, Associate General Counsel, Regulatory Practice & Policy, NASD

MANAGED FUNDS ASSOCIATION

VIA ELECTRONIC MAIL: PUBCOM@NASD.COM

March 12, 2004

Ms. Barbara Z. Sweeney
Senior Vice President and Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1500

Re: NASD Notice to Members 04-07: Policy on Trail Commissions in Publicly Offered Commodity Pools

Dear Ms. Sweeney:

MFA welcomes the opportunity to comment upon the NASD's proposal to rescind its long-standing policy with respect to compensation paid to CFTC-regulated brokers who place interests in a publicly offered commodity pool and provide ongoing services to investors in the pool ("trail commissions"). Under that policy, trail commissions have not been deemed to be sales compensation, subject to the limitations in NASD Rule 2810, for over 20 years. As demonstrated in this letter, MFA believes that the NASD's policy should be codified rather than rescinded in order to permit the continued efficient operation of commodity pools, including provision of important services to commodity pool investors.

MFA is the only US-based membership organization dedicated to serving the needs of professionals who manage managed futures funds, hedge funds, and fund of funds. Our over 700 members manage a significant portion of the estimated $750 billion invested in these alternative investment vehicles. Among the MFA membership are commodity pool operators (CPOs), commodity trading advisors (CTAs), as well as NASD-member broker-dealers, who represent a significant portion of the estimated $87 billion invested in managed futures products, including publicly offered commodity pools. Accordingly, MFA's members have a keen interest in the proposals set forth in NASD's Notice to Members 04-07.

What are Commodity Pools? For purposes of this letter, commodity pools are publicly offered collective investment vehicles that trade in futures contracts and options on futures contracts ("futures"). Some also trade in spot and forward foreign currencies. Commodity pools do not trade in securities, although some may maintain cash balances in Treasury bills or other cash equivalents. Commodity pools are not investment companies as defined under the

Investment Company Act of 1940. Recent industry estimates indicate that there are about 55 public pools in the United States aggregating approximately $9 billion.[1]

Trading in futures is subject to the jurisdiction of the Commodity Futures Trading Commission ("CFTC") under the Commodity Exchange Act ("CEA"). The CFTC under the CEA also regulates the professionals involved in futures, including commodity pool operators ("CPOs"), commodity trading advisors ("CTAs") and futures commission merchants ("FCMs"). Each commodity pool has one or more CPOs, CTAs and FCMs. The CPO of a pool in the form of a limited partnership is its general partner. The CTA may be the CPO or one or more unaffiliated persons who provide trading advice to the pool with respect to futures. The FCM is the commodity broker that carries the commodities account(s) of the pool. The FCM may execute and clear all trades for the pool or trades may be executed by other firms and "given-up" to the FCM for clearing. Each of the CPOs, CTAs and FCMs for commodity pools is registered with the CFTC and is a member of NFA, the futures self-regulatory organization. Each is subject to the rules of the CFTC and the NFA.

Commodity pools pay management and incentive fees to their CTAs for commodity trading advice and brokerage commissions to their FCMs for commodity brokerage services. Some pools also pay administrative fees to their CPOs. Trail commissions are typically portions of the commodity brokerage commissions paid by the pool. Such commissions may be charged as a flat percentage of assets on a monthly basis or as round-turn commissions for each futures trade. In some pools trail commissions may be portions of the management or administrative fees paid by the pool. We know of no pool in which trail commissions are a separate charge to the pool or a charge deducted from an investor's subscription amount as suggested in the Notice to Members. In all cases, trail commissions are payments for ongoing services provided to the pool and its investors. Trail commissions are not selling commissions deducted from an investor's subscription amount and paid to a selling agent.

It should be noted that the prospectus and offering materials for commodity pools are reviewed by the Securities and Exchange Commission ("SEC"), the NASD, the CFTC/NFA and many of the states. All of the fees payable by commodity pools, including those from which trail commissions are paid and the level of trail commissions paid, are required to be disclosed in the prospectus. The facts that trail commissions will be paid, the amount of the trails and the conflicts of interest related to payment of trails are disclosed, along with a description of the services provided. In addition, since trails are paid from other forms of compensation, which are themselves limited in amount by the NASAA Commodity Pool Guidelines, trails are indirectly regulated.

In over twenty years of history, publicly offered commodity pools have had no history of abuses; and, more specifically, there is no history of abuses connected with the

---

1 *See MAR/Hedge Report* (February 2004), *Stark Trader Analysis Report* (February 2004) for public commodity pool industry statistics as of January 31, 2004.

payment of trail commissions. In addition, over this period, advisory and brokerage fees paid by public commodity pools have been substantially reduced, presumably as the result of competition. While it is not possible to foresee the consequences of rescission of the NASD's trail policy on future offerings of public commodity pools, it is likely that the result would be a decrease in the number of pools offered to the public. Reduction in the number of publicly offered pools could lead to reduced competition and more rigid pricing.

Benefits of Commodity Pools. Commodity pools are generally acknowledged by regulators and the financial press as offering the safest and least expensive mechanism for retail investors to engage in futures trading for investment and/or portfolio diversification purposes through the inclusion of a non-correlated investment to a traditional stock and bond portfolio: pools offer daily net asset valuation, liquidity in the form of monthly (or, more recently, even daily) redemption rights, and professional trading and fund management. These pools are highly regulated and provide limited liability for investors, as well as containing higher suitability standards and solicitation restrictions than other commodity-related investments. For example, individual managed futures accounts are subject to CFTC/NFA regulation, but are not subject to SEC, NASD or state jurisdiction and have unlimited liability, typically higher fees, restricted access to advisors and less regulatory oversight.

Moreover, these commodity pools provide retail investors with access to many of the most successful CTAs. This access would be severely curtailed if commodity pools were not available, due to the large minimum account size requirements of many of those CTAs and the higher suitability requirements and capital obligations of privately offered commodity pools. In addition, portfolio diversification is a basic tenet of modern investment theory. Studies have shown an historical lack of correlation between the performance of managed futures and the performance of the stock and bond components of a traditional investment portfolio. Therefore, pools provide potential diversification from stock and bond portfolios. In fact, most pools offered today are offered as part of a portfolio diversification strategy. If the NASD's policy on trail commissions is rescinded as proposed, and as a result, the number of publicly offered commodity pools is severely reduced, retail investors will be denied access to the only affordable futures-based product currently available in a limited liability structure (i.e., a limited partnership or limited liability company) and to one of the only alternative investment products available to diversify a traditional stock and bond portfolio.

Finally, one of the main functions of futures trading is to provide price discovery with respect to the underlying commodity. In order for futures markets to perform this function, both speculators and hedgers must use the markets. These commodity pools provide a significant source of speculative capital for the United States futures markets that might be curtailed by rescission of the NASD's policy on trail commissions. This could lead to reduced liquidity and volume on U.S. exchanges, and consequently have an adverse effect on the price discovery function performed by those markets.

Justifying Trail Commissions. Trail commissions are service fees paid for commodity-related services. Trail commissions developed from and are consistent with practices of FCMs with respect to individual customer futures accounts. Associated persons of FCMs who service those futures accounts typically share in the commodity brokerage commissions generated by the accounts. Thus, the qualification requirements applicable to recipients of trail commissions are similar to those applicable to associated persons who limit their activities to individual customer futures accounts.

Those who receive trails must qualify to receive them by registering as associated persons under the CEA and must first pass either the Series 3 or the Series 31 examination which requires a demonstrated competency in commodity-related matters. As registrants under the CEA, these individuals are subject to sanctions under the CEA and related rules (including those of the CFTC and NFA). Registrants are also subject to periodic ethics training requirements.

The services provided by associated persons in return for the trails require knowledge of both the product and the commodity markets. The services generally described in the prospectuses of publicly offered commodity pools are: (a) responding to inquiries from investors about the value of units; (b) providing information and responding to inquiries about the futures and forward markets and the fund's trading in those markets; (c) responding to limited partners' inquiries about monthly statements and annual reports and tax information provided to them; (d) providing information to investors about redemption rights and procedures; (d) assisting investors in redeeming units; and (e) providing other services requested from time to time by investors.

As noted above, commodity pools are often offered as part of a portfolio diversification strategy. Consequently, associated persons may be required to monitor the traditional elements of an investor's portfolio as well as the futures component.

If associated persons did not provide these services to pool investors, the pool's CPO would have to incur additional expenses to develop an alternative mechanism for providing such services to pool investors.

Commodity Pools are Different. The regulatory requirements that apply to publicly offered commodity pools exceed considerably those that apply to other limited partnership programs. Those products, such as real estate or oil and gas partnerships, are not subject to a separate federal regulatory framework. Commodity pools and commodity professionals, as noted above, are subject to regulation by the CFTC and NFA under the CEA.

Many states substantively review prospectuses for public pools and impose investor suitability requirements (income and/or net worth - exclusive of home, furnishings and automobiles) on public pool participants. In fact, most states have adopted the NASAA Guidelines for Commodity Pools, which set forth requirements for and limitations on the operation of commodity pools. Limitations include maximum fees to be charged. The current Guidelines specifically permit payment of trail commissions. In contrast, states do not review the prospectuses of registered investment companies and almost anyone can purchase shares in them.

Publicly offered commodity pools also differ from other direct participation programs subject to NASD Rule 2810 in significant structural and operational ways. For example, real estate and oil and gas partnerships typically purchase properties or other assets at the outset of operations and then hold those properties or assets until the termination of the partnership. Although these programs provide annual financial statements, they often do not provide daily net asset values and typically do not permit regular redemptions. Commodity pools, on the other hand, engage in daily trading of multiple futures contracts on multiple markets. Commodity pools are required to provide daily net asset values. Commodity pools provide redemption opportunities on at least a monthly basis. In addition, most commodity pools engage in continuous offerings of interests, at least until such time as a maximum level of assets is reached. As a result of these differences, investors require more and different information than investors in other direct participation programs.

Commodity pools bear certain similarities to closed-end investment companies subject to Rule 2810. These investment companies engage in investments over the life of the fund and may provide redemption opportunities by electing to be treated as an "interval fund." However, investment companies typically have a much lower portfolio turnover rate than commodity pools and often seek to generate long-term capital gains by holding positions for at least a year, whereas commodity pools often engage in short-term trading activity, placing trades on a daily basis. Thus, investors in commodity pools may require information with respect to trading on a daily basis. In addition, the redemption opportunities, if any, afforded by closed-end investment companies are not as frequent as commodity pools. Thus, investors in commodity pools may require information and/or advice from their associated persons in making frequent decisions on whether or not to redeem or purchase more units.

Conclusion. As demonstrated in this letter, trail commissions derive from the futures industry practice with respect to individual futures accounts, are paid out of legitimate and regulated fees paid by commodity pools rather than assessed separately against an investor's subscription amount and are fully disclosed as required by federal and state regulators. In addition, commodity pools and the services provided in return for trail commissions may be distinguished from other direct participation programs. Therefore, MFA believes that the NASD's long-standing policy excluding trail commissions from the limitations in Rule 2810 should be codified rather than rescinded. Such codification will permit the continued efficient operation of publicly offered commodity pools, including provision of important services to commodity pool investors.

We stand ready to meet with you and your colleagues at the NASD to discuss the comments set forth above. I can be reached at 202.367.1140.

Sincerely,

/s/ John G. Gaine
John G. Gaine
President

[*Continued on next page.*]

cc: Mary L. Schapiro
Vice Chairman and President, Regulatory Policy and
Oversight, NASD

Thomas M. Selman,
Senior Vice President, Investment Companies/Corporate Financing, NASD

Joseph E. Price
Vice President, Corporate Financing, NASD

Gary Goldsholle
Associate General Counsel, Regulatory Practice & Policy, NASD

MANAGED FUNDS ASSOCIATION

October 7, 2004

By E-Mail: rule-comments@sec.gov

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609
Attention: Mr. Jonathan G. Katz, Secretary

Re: **Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to the Implementation Date of Notice to Members 04-50 (Treatment of Commodity Pool Trail Commissions Under Rule 2810); Release No. 34-50335; File No. SR-NASD-2004-136 (the "Release")**

Ladies and Gentlemen:

Managed Funds Association ("MFA") is the only US-based membership organization dedicated to serving the needs of professionals who manage futures funds, hedge funds, and funds of funds. Our over 800 members manage a significant portion of the estimated $750 billion invested in these alternative investment vehicles. Among the MFA membership are commodity pool operators ("CPOs"), commodity trading advisors ("CTAs") and futures commission merchants ("FCMs"), as well as NASD-member broker-dealers, who provide their respective services in connection with a significant portion of the estimated $87 billion invested in managed futures products, including publicly offered commodity pools. Accordingly, MFA's members have a keen interest in the proposals set forth in the Release and in the NASD's policy on trail commissions.

MFA has addressed the NASD's proposed rescission of its trail commissions policy twice before. In its comment letter to NASD on Notice to Members 04-07 dated March 12, 2004 (the "NASD Comment"), the MFA explained its belief that the NASD's policy should be codified rather than rescinded, to permit the continued efficient operation of commodity pools, including provision of important services to commodity pool investors. In its comment letter to the Securities and Exchange Commission ("Commission") dated August 20, 2004 (the "SEC Letter"), MFA established its beliefs that (i) the NASD's proposal to rescind its policy constitutes a significant rule change that should have been accorded the required notice and comment period prior to its effectiveness under Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Exchange Act"), and (ii) the Commission should abrogate the effectiveness of the proposal or permit the NASD to withdraw and revise it because it is inconsistent with the provisions of the Exchange Act applicable to the NASD. Copies of MFA's prior letters are attached.

By extending the effective date for rescission of its policy on trail commissions, the NASD has corrected the short-term negative effect of its action on those pools involved in the registration process as of July 13, 2004. The NASD has not, however, either in the Release or in its letter to the SEC dated August 30, 2004 (the "Rebuttal"), adequately addressed the main issues raised in the SEC Letter.

First, the NASD's proposed rule change is a significant rule change that should be accorded the required new notice and comment period prior to its effectiveness under Section 19(b)(1) of the Securities Exchange Act. At the end of such a period, the Commission would be in a position to weigh for itself the merits of the proposal against its potential burdens. The reasons and precedent supporting this position appear in the SEC Letter.

Second, the proposal is inconsistent with the Sections 15A(b)(6) and (9) of the Exchange Act, and so the Commission should exercise its power under Exchange Act Section 19(b)(3)(A) to summarily abrogate the NASD policy and require that it be refiled under Section 19(b)(1). The NASD has not addressed either of the MFA's arguments with respect to Section 15A(b)(6) in the SEC Letter. The proposed rule permits "unfair discrimination between customers, issuers, brokers, or dealers . . . ." in that it may result in discrimination between commodity pools and futures managed accounts. Further, the proposed rule purports to "regulate by virtue of any authority conferred by [the Exchange Act] matters not related to the purposes of [the Exchange Act] or the administration of the [NASD]" in that the activities of commodity pools are regulated by the Commodity Futures Trading Commission and the National Futures Association. These arguments are expanded in the SEC Letter.

The NASD addressed the first of MFA's arguments under Section 15(A)(b)(9) by extending the effective date. The NASD did not, however, address the argument in the SEC Letter concerning barriers to entry that will be erected by the proposal.

Moreover, in its Rebuttal, the NASD attempts to establish that the proposed rule is in the public interest. It does so by stating that (i) trail commissions are "excessive" and that (ii) "[u]niformity in the application of Rule 2810 serves an important public interest." It is difficult to understand why the NASD is empowered to determine that trail commissions earned for commodity related services are "excessive" when, as demonstrated by the NASD Comment and other comments provided by industry participants, trail commissions are consistent with commission charges generally in the managed futures industry. In addition, NASD rules governing sales compensation are not uniform currently. Investment companies and real estate investment trusts, for example, are treated differently from other entities. Therefore, it is impossible to determine that uniformity is the hallmark of the public interest. As demonstrated by MFA and other industry participants in their comment letters to the NASD and the Commission, commodity pools differ from other types of investment vehicles and those differences, including the complexity of futures trading and regulation by a separate federal regulator, warrant different treatment by NASD rules, as has been accorded for over 20 years under the existing trail commissions policy.

Finally, in its Rebuttal, the NASD states that the "calls for abrogation are simply an attempt to impose a procedural hurdle to delay the impact of NtM 04-50." The administrative procedures required by and of the U.S. government and its agencies are not impediments to good government, but necessities of good government. As the Supreme Court has regularly reminded us, people must turn square corners when dealing with the government, but so too must government turn square corners when dealing with people. *See, e.g.,* U.S. v. Winstar Corp, 518 U.S. 839, 886, n.31 (1996); Heckler v. Community Health Services of Crawford Cty., Inc., 467 U.S. 51, 61, n.13 (1984); St. Regis Paper Co. v. United States, 368 U.S. 208, 229 (1961) (Black, J., dissenting); Federal Crop Insurance Corp. v. Merill, 322 U.S. at 387-388 (1947)(Jackson, J. dissenting).

In conclusion, for the reasons outlined in MFA's NASD Comment and its SEC Letter, the SEC should abrogate the proposal or permit the NASD to withdraw and revise it in order to cure its flaws and, if a proposal is resubmitted, require that the public be afforded a formal notice and a comment period before approval or disapproval of the proposed rule.

We hope our comments are helpful to the Commission and its staff. Please call me at (202) 367-1140 if we can provide additional information.

Respectfully submitted,

John G. Gaine
President

Attachments: MFA's letter dated March 12, 2004
MFA's letter dated August 20, 2004

cc(w/att.): The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Harvey J. Goldschmid, Commissioner
The Hon. Roel C. Campos, Commissioner
Annette L. Nazareth, Esq., Director
Division of Market Regulation
Robert L. D. Colby, Esq., Deputy Director
Division of Market Regulation
Elizabeth King, Associate Director

Division of Market Regulation
Giovanni P. Prezioso, Esq., General Counsel

NASD

Mary L. Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, NASD
Barbara Z. Sweeney, Senior Vice President and Corporate Secretary NASD
Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, NASD
Joseph E. Price,Vice President, Corporate Financing, NASD
Gary Goldsholle, Associate General Counsel, Regulatory Practice & Policy, NASD

MANAGED FUNDS ASSOCIATION

August 20, 2004

By E-Mail: rule-comments@sec.gov

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609
Attention: Mr. Jonathan G. Katz, Secretary

Re: Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to the Treatment of Commodity Pool Trail Commissions; Release No. 34-50065; File No. SR-NASD-2004-108 (the "Release")

Ladies and Gentlemen:

Managed Funds Association ("MFA") welcomes the opportunity to comment on the Release concerning the NASD's proposal to rescind its long-standing policy with respect to compensation paid to CFTC-regulated brokers who place interests in a publicly offered commodity pool and provide ongoing services to investors in the pool ("trail commissions"). We hope our comments prove helpful to the Commission.

Under the NASD's policy, trail commissions have not been deemed to be sales compensation, subject to the limitations in NASD Rule 2810, for over 20 years. MFA believes that the NASD's policy should be codified rather than rescinded, to permit the continued efficient operation of commodity pools, including provision of important services to commodity pool investors. The reasons for MFA's belief were set forth in its letter dated March 12, 2004 on Notice to Members 04-07 (the "MFA Letter"), a copy of which is attached As we discuss below, moreover, MFA believes that (i) the NASD's proposal to rescind its policy constitutes a significant rule change that should have been accorded the required notice and comment period prior to its effectiveness under Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Exchange Act"), and (ii) the Commission should abrogate the effectiveness of the proposal or permit the NASD to withdraw and revise it because it is inconsistent with the provisions of the Exchange Act applicable to the NASD.

MFA is the only US-based membership organization dedicated to serving the needs of professionals who manage futures funds, hedge funds, and funds of funds. Our over 700 members manage a significant portion of the estimated $750 billion invested in these alternative investment vehicles. Among the MFA membership are commodity pool operators ("CPOs"), commodity trading advisors ("CTAs") and futures commission merchants ("FCMs"), as well as NASD-member broker-dealers, who provide their respective services in connection with a significant portion of the estimated $87 billion invested in managed futures products, including publicly offered commodity pools. Accordingly, MFA's members have a keen interest in the proposals set forth in the Release and in the NASD's policy on trail commissions.

I. Background.

As noted above, the NASD policy, under which commodity pool trail commissions have been excluded from the limitations in NASD Rule 2810, has been in place for over 20 years. The exclusion was reconfirmed in the NASD approval process of the underwriting arrangements for every public commodity pool registered under the Securities Act of 1933 during that time. The sponsor of the pool was required to represent that (i) trail commissions would be paid only to FCMs or introducing brokers ("IBs") registered with the Commodity Futures Trading Commission ("CFTC"), (ii) FCMs or IBs would share trail commissions only with their associated persons who were registered with the CFTC, having passed the Series 3 or 31 Exam and (iii) associated persons receiving trail commissions would provide ongoing services to investors in the pool.

In the fall of 2003, NASD staff began questioning the exclusion for trail commissions in its review of several new commodity pool filings. Industry participants met with NASD staff to provide them information concerning the operation of commodity pools and the commercial need for payment of trail commissions. On March 12, 2004 in Notice to Members 04-07, the NASD proposed rescinding its exclusion from Rule 2810 for commodity pool trail commissions and requested comments from interested persons. As stated in the Release, the NASD received 26 comment letters, almost all of them opposed to the rescission. Letters were received from NASD members, CPOs and CTAs, industry groups, regulators and self-regulators and the Association of the Bar of the City of New York. Nonetheless, on July 13, 2004, the NASD issued its Notice to Members 04-50 (the "Notice"), which rescinded the NASD policy on trail commissions, effective immediately.

The Notice did not provide a detailed summary or analysis of the arguments and issues raised in the comment letters opposed to the rescission. The Notice baldly stated that the reasons underlying the trail commissions policy "no longer apply today", and that no evidence was presented that "commodity pool DPP investors receive a significantly higher level of service than investors in other DPPs." In fact, that simply was not true. Commodity pool investments are more complex and less widely understood than stocks, bonds, real estate or physical commodities like oil and gas. As a result, investors in commodity pools receive a significantly higher level of services than investors in other DPPs. Provision of those services, moreover, is a commodity-related activity, as it has been for over 20 years. These points were amply demonstrated in comment letters on Notice to Members 04-07, including the MFA Letter.

In the short run, as a result of this precipitous action of the NASD, registrations of at least two public commodity pools pending with the NASD have been disrupted. These offerings will have to be altered or withdrawn. The sponsors of these offerings have expended substantial amounts to prepare and file documents which complied with NASD rules in effect before July 13, 2004, but no longer comply as a result of the rescission in the Notice.

In the longer run, the action of the NASD will impede the growth and operation of an industry that provides public investors with alternative investment opportunities that are not available elsewhere. A description of the industry, the benefits to the public of commodity pools and the arguments against rescission of the policy on trail commissions appear in the attached MFA Letter.

II. Procedures to Implement Rule Changes.

The NASD's 20-year policy of excluding trail commissions from the limitations in Rule 2810 amounted to a de facto rule. Therefore, the proposal to rescind the policy on trail commissions should be regarded as a proposed rule change, rather than a change in interpretation of an existing rule. The NASD should have filed its proposal as a proposed rule change under Section 19(b)(1) of the Exchange Act without reliance on the exception from the notice-and-comment period that permits immediate effectiveness for changed interpretations of an existing rule. Had the NASD followed this procedure, the proposal would have been published in the Federal Register, comments would have been solicited and the Commission would have been able to review and evaluate those comments, all before the proposal became effective - in accord with the Congressional intent underlying the Commission's oversight of the NASD.

As the Commission is aware, the NASD is generally required to file proposed rule changes with the Commission and obtain Commission approval before the rule changes can become effective. An exception to this general requirement in Exchange Act Section 19(b)(3)(A) and Rule 19b-4(f)(1) permits a self-regulatory organization ("SRO") to declare a rule change effective upon filing with the SEC if the SRO designates the rule change to be a "stated policy, practice or interpretation with respect to the meaning, administration, or enforcement of an existing rule" of the SRO. Exchange Act Rule 19b-4(b) defines the term "stated policy, practice or interpretation" to mean, in pertinent part, any statement made generally available to the membership of, to all participants in, or to persons having or seeking access to the facilities of the SRO that establishes or changes any standard, limit, or guideline with respect to (i) the rights, obligations or privileges of such persons or (ii) the meaning, administration or enforcement of an existing rule. Rule 19b-4 goes on to state that a stated policy, practice or interpretation shall be deemed a rule change unless (i) it may be reasonably and fairly implied by an existing rule or (ii) it is concerned solely with the administration of the SRO.

The NASD's policy of excluding trail commissions from the application of Rule 2810, although not literally a written provision included in Rule 2810, has operated as such a written exclusion would have operated for over 20 years. The NASD has uniformly applied the exclusion as if it were a rule during all that time. The exclusion has been applied in written form through the means of comment letters on specific underwriting arrangements issued by NASD staff. The entire commodity pool industry has relied on the exclusion in offering and operating

Respectfully submitted,

John G. Gaine
President

Attachment: MFA's letter dated March 12, 2004

cc(w/att.): The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Harvey J. Goldschmid, Commissioner
The Hon. Roel C. Campos, Commissioner
Annette L. Nazareth, Esq., Director
Division of Market Regulation
Robert L. D. Colby, Esq., Deputy Director
Division of Market Regulation
Elizabeth King, Associate Director
Division of Market Regulation
Giovanni P. Prezioso, Esq., General Counsel

<u>NASD</u>

Mary L. Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, NASD
Barbara Z. Sweeney, Senior Vice President and Corporate Secretary NASD
Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, NASD
Joseph E. Price,Vice President, Corporate Financing, NASD
Gary Goldsholle, Associate General Counsel, Regulatory Practice & Policy, NASD