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 MFA believes that the NASD's policy should be codified rather than rescinded, to permit the continued efficient operation of commodity pools, including provision of important services to commodity pool investors.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