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August 30, 2004

Katherine A. England
Assistant Director
Division of Market Regulation
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C.

Re: File No. SR-NASD-2004-108 – Response to Comment Letters

Dear Ms. England:

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is submitting to the Securities and Exchange Commission (“Commission”) this response to comments to SR-NASD-2004-108, which applies the compensation limits in Rule 2810 (“Direct Participation Programs Rule” or “DPP Rule”) to commodity pool direct participation programs. Specifically, this letter responds to the comment letters from Beacon Management Corporation dated August 19, 2004, The Association of the Bar of the City of New York, Committee on Futures Regulation (“NY City Bar”) dated August 20, 2004, John W. Henry & Company, Inc. (“JWH”) dated August 20, 2004, the National Futures Association (“NFA”) dated August 20, 2004, Campbell & Company dated August 20, 2004, Citigroup Managed Futures LLC dated August 20, 2004, and the Managed Funds Association (“MFA”) dated August 20, 2004, to the above-referenced rule filing.

All but one of the comment letters request that the Commission abrogate the policy set forth in NASD *Notice to Members 04-50* (“*NtM 04-50*”), in which NASD states that staff will consider all trail commissions paid in connection with commodity pool DPPs in calculating whether the level of underwriting compensation meets the requirements of Rule 2810.¹ NFA’s comment letter does not seek abrogation but simply

¹ While the NY City Bar letter calls for abrogation, its initial comment letter did not oppose NASD’s proposal on specific substantive grounds. The comments of the NY City Bar in its letter dated March 12, 2004, were focused primarily on procedural matters, including timing and the impact on existing commodity pool DPPs. *NtM 04-50* addressed these concerns in announcing the effective date of the policy and explaining that NASD’s policy does not alter the compensation that may be paid in offerings of commodity pool DPPs that have already received a “no-objections” opinion from NASD’s Corporate Financing Department.

asks that the effectiveness of the policy be delayed to avoid undue hardship on two commodity pools that are in the middle of the registration process.²

I. Legal Standard

As the Commission is aware, Section 19(b)(3)(A) of the Act and Rule 19b-4(f)(1) thereunder permit a proposed rule change of an SRO to take effect upon filing if, among other things, it “[c]onstitutes a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule.” For the reasons set forth below, NASD’s *NiM 04-50* was properly designated as eligible for immediate effectiveness.

In addition, the Commission should not find that abrogation is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. As is demonstrated below, the interests of investors and the public are promoted by the rule change.

II. Background

NASD’s DPP Rule governs public offerings of direct participation programs, including establishing limits on the level of underwriting compensation. Specifically, the DPP Rule requires that, prior to participating in a public offering of securities, a member (or another member on its behalf) must file information regarding the DPP offering with NASD’s Corporate Financing Department (“Department”) and receive a “no-objections” opinion. The “no objections” opinion takes into account the level of underwriting compensation, which may not exceed 10 percent of the gross proceeds of the offering. In calculating the level of underwriting compensation for commodity pool DPPs, the Department had previously excluded certain trail commissions paid to an associated person of a member if: (1) the member was registered with the Commodity Futures Trading Commission as a Futures Commission Merchant; (2) the associated person receiving the trail commissions had passed the National Commodity Futures Examination (Series 3) or the Futures Managed Funds Examination (Series 31); and (3) the associated person receiving the trail commissions provided ongoing investor relations services to the investors. NASD did not publish this policy, and the DPP Rule was never amended to exclude these payments from the compensation limitations.

² While NFA’s letter discusses the possibility of abrogation, we understand that NFA’s concerns are limited to the impact on the two commodity pools that were in the middle of the registration process and that NFA has not called for abrogation. NASD has discussed *NiM 04-50* with both of the issuers and proposes to address each on an individual basis, as discussed in Section IV.A below. NASD further understands that the reference to abrogation was included because NFA was aware the MFA was submitting a comment letter to the SEC and that abrogation would be one of several possible means of addressing the impact on the two commodity pools.

In *Notice to Members 04-07* (“*NtM 04-07*”), issued in February 2004, NASD announced that it proposed to no longer apply its unwritten policy of excluding trail commissions paid to eligible registrants in connection with the sale of commodity pool DPPs. *NtM 04-07* invited comment and asked specific questions. NASD received 26 comment letters from industry participants, state securities regulators, and a self-regulatory organization. (The substance of these comment letters is discussed below.)

In *NtM 04-50*, NASD announced that it was no longer going to exclude the payment of any trail commissions for commodity pool DPPs from the underwriting compensation limits of Rule 2810. *NtM 04-50* announced that, “effective immediately, in determining whether to issue a ‘no objections’ opinion in connection with a commodity pool DPP filed with the Department under Rule 2810, NASD staff will consider, among other things, whether the level of underwriting compensation, including the types of trail commission previously excluded, exceeds the 10% limitation in the DPP Rule.”

III. *NtM 04-50* Was Properly Filed Under Section 19(b)(3)(A) Because it is a Stated Policy, Practice, or Interpretation With Respect to the Meaning, Administration, or Enforcement of an Existing Rule

The policy announced in *NtM 04-50* is precisely the type of rule change that is eligible for filing under Section 19(b)(3)(A) and Rule 19b-4(f)(1). In *NtM 04-50*, NASD announced that it would apply the compensation limits set forth in Rule 2810 to include all trail commissions paid by commodity pool DPPs. *NtM 04-50* does not amend any text of Rule 2810 nor does it amend any published statements of NASD in connection with rulemaking. Rather, *NtM 04-50* announces that NASD staff will count all trail commissions paid by commodity pool DPPs towards the compensation limitations in the Rule before issuing an opinion that NASD has “no objections” to the underwriting terms and arrangements and to the offering proceeding (a stated policy, practice or interpretation) in compliance with the requirements of Rule 2810 (with respect to the meaning, administration, or enforcement of an existing rule). *NtM 04-50* conforms NASD’s policy to apply Rule 2810 to all DPP offerings in a manner that tracks with the express meaning of the Rule approved by the Commission.

IV. Abrogation of *NtM 04-50* is Not in the Public Interest

Some of the commenters also argue that the Commission should exercise its abrogation power in the interest of the public and investors. NASD respectfully disagrees.

A. *NtM 04-50 Does Not Disrupt Two Commodity Pool DPP Registrations Pending Before the Department*

Abrogation of the rule change is not justified because of the impact on two commodity pool registrations pending before the Department as MFA, NFA and JWH claim. In February 2004, when it published *NtM 04-07*, commodity pool DPPs were put on notice that NASD was proposing to rescind the policy. Thus, in the five intervening months between publication of *NtM 04-07* and rescission of the policy, commodity pools could have, and should have, begun to plan for the possibility of rescission.

Nevertheless, NASD staff was, and continues to be, mindful of the impact of *NtM 04-50* on commodity pool DPPs that are in the process of registration at the time NASD issued *NtM 04-50*. On July 13, 2004 when *NtM 04-50* was published, the staff was not aware of any commodity pool DPP offerings pending in the Department. As such, it saw no need to “grandfather” commodity pools that were in the process of registration. The two commodity pool DPPs that have subsequently been identified as in the process of registration did not properly disclose in their COBRA filings with the Department that they intended to pay trail commissions.³ NASD staff has had conversations with both of these commodity pool DPPs concerning the application of the policy set forth in *NtM 04-50* and has invited these commodity pools to present in writing any undue hardships that they may face. NASD staff believes that any undue hardships faced by these two issuers with respect to these two filings can and should be addressed on a case-by-case basis.⁴

The argument that abrogation is required under Section 15A(b)(9) because of the purported burden on competition also is flawed. The impact of *NtM 04-50* on the two commodity pools, which has yet to be quantified, is not a basis for abrogation. Moreover, we learned from discussions that one of the commodity pool DPPs was not aware that commenters were seeking abrogation, and it is not a member of the trade association claiming to represent its interests. The claim of undue hardship on these two commodity pools is not the issue here; rather, the industry seeks to preserve the status quo.

³ Accordingly, when the staff queried the COBRA database, these deals were not retrieved as commodity pool DPPs that proposed to charge trail commissions.

⁴ Citigroup Managed Futures (“CMF”), a third commodity pool DPP, claims that it is also impacted by the issuance of *NtM 04-50* because it had filed a registration statement with the Commission on July 8, 2004. CMF made its initial filing with NASD on July 13, 2004 although NASD Rule 2710 requires filings to be made on the day following filing with the SEC. As with the other two commodity pool DPPs in the process of registration, NASD staff believes that any undue hardship can be addressed on a case-by-case basis.

B. The Public Interest and Investors are Served by
Maintaining *NtM 04-50*

Maintenance of the policy announced in *NtM 04-50* furthers the public interest and the protection of investors. Rule 2810 proscribes standards of fairness and reasonableness for public offerings of DPP programs and incorporates the 10% underwriting compensation limitation. *NtM 04-50* seeks to ensure that these limits are followed. In the absence of such limits, many funds have established perpetual trail commissions as high as 4%. These levels are excessive. Even some participants in the commodity pool industry have conceded that the services may be excessive and suggested a “reasonable range,” such as a 2% yearly limit. NASD has sought to advance the public interest and the protection of investors by requiring that commodity pool DPPs conform their fees to those allowed under the DPP Rule, in a manner consistent with all other DPPs.

Uniformity in the application of Rule 2810 serves an important public interest. The opportunity for a registered representative to receive outsized compensation for selling one type of DPP over another raises obvious investor protection concerns. Excluding trail commissions from commodity pool DPPs has led to a level of trail commissions that are unmatched in any other publicly offered security. Public offerings of all other DPPs, including oil and gas programs (which underlying products are commodities), real estate programs, agricultural programs (which underlying products are often commodities), cattle programs (which underlying product is a commodity), condominium securities, and Subchapter S corporate offerings, are subject to the 10% compensation limit and investors can not be required to pay any additional commissions once the 10% limit is reached. Commodity pool DPPs, by contrast, have developed trail commissions as high as 4% annually as long as an investor holds the securities in his or her account.

Several of the commenters seek to justify the policy of excluding trail commissions from the compensation limitations as based upon a higher level of service they provide. NASD does not view the services provided to securities accounts holding commodity pool DPP investments as fundamentally different from the services provided to accounts holding other types of DPPs. The fact that the underlying assets in commodity pool DPPs are futures contracts rather than, for example, oil and gas wells or real estate investments does not change this analysis. Commenters have not demonstrated that commodity pool investors receive a significantly higher level of service than investors in other DPPs. The commenters argue that commodity pool investments are more complex and less widely understood than other investments such as stocks, bonds, options, real estate programs, agricultural and cattle programs, and condominium securities. This argument, even if it were valid, fails to address the fact that commodity pools are also sold by people who are not entitled to receive uncapped trail commissions (because, *e.g.*, they have not passed the Series 3 or 31).

In this regard, in response to a specific question in *NtM 04-07*, commenters were unable to differentiate the level of service provided by persons who passed the Series 3 or 31 (and thus met the exclusion) and those who have not (and thus remained subject to the compensation limits of the DPP Rule). Moreover, even if there were differences in services provided by Series 3 and 31 persons, Rule 2810 does not (and should not be construed to) permit such persons to receive unlimited trail commissions. Assuming *arguendo* that persons who have passed the Series 3 and Series 31 exams (and meet the other criteria) provide additional services to commodity pool DPP investors, such additional services clearly should not justify unlimited trail commissions.

Commenters stressed that commodity pool DPPs are a popular and valuable component of diversified portfolios that benefit investors, but argued conversely that without uncapped trail commissions, registered representatives would stop offering these products to investors. We note, however, that rescinding the exclusion does not prohibit trail commissions in commodity pool DPPs, it merely limits them to the amounts that can be charged under Rule 2810 in connection with every other kind of DPP. NASD does not accept the argument that unless registered representatives are eligible to receive uncapped, unlimited fees they would not recommend a commodity pool DPP to their customers if the commodity pool DPP is a useful and appropriate investment.

The application of the compensation limitations to trail commissions in commodity pool DPPs does not prevent registered representatives who sell commodity pool DPPs from earning compensation. Rather, NASD is requiring commodity pool DPPs to structure their compensation limits to comply with the standards contained in Rule 2810. Under the policy in *NtM 04-50*, a commodity pool DPP could pay a registered representative the 10% compensation limitation in full at the time of the investment or spread out over time (*e.g.*, 2% per year for 5 years, or 1% per year for 10 years, or some other combination limited to an aggregate of 10%). Imposing such compensation limits is not contrary to the public interest.

C. NASD's Internal Processes Elicited Substantial Public Comment

NASD has already provided the parties seeking abrogation an opportunity to comment. Before changing the treatment of certain trail commissions, NASD voluntarily invited industry comment in *NtM 04-07*. NASD was not compelled by its By-Laws or the Act to seek public comment, but did so in the interests of reaching an informed decision.⁵ NASD's policy reflects a careful consideration of the comments received. While many industry commenters opposed any change in policy, NASAA and the

⁵ Indeed, the Department could simply stopped excluding certain trail commissions, and this matter would not have come before the Commission. In the interests of transparency and full public comment, however, NASD first sought comment before making the change.

Commonwealth of Massachusetts Securities Division strongly supported the proposal. Notably, NFA, which developed the Series 3 and 31 examinations, and which regulates futures commission merchants (including broker-dealers that became futures commission merchants to avail themselves of the exclusion under the old policy), did not oppose the proposal. The calls for abrogation raise no new substantive issues. All of the substantive issues presented in the comment letters seeking abrogation were already presented to NASD in response to *NtM 04-07*. The calls for abrogation are simply an attempt to impose a procedural hurdle to delay the impact of *NtM 04-50*.

V. Commission Abrogation Would Not Bring About Any Substantive Change

Finally, NASD does not believe that abrogation would alter the outcome for commodity pool DPPs. As has been stated above, the text of the DPP Rule does not provide any express exclusion for trail commissions for commodity pool DPPs. For many years, NASD has in effect “exempted” certain trail commissions. Even if *NtM 04-50* were abrogated, NASD would not be compelled to exercise its exemptive authority to issue “no-objections” opinions for commodity pool DPP offerings that exceed the compensation limits set forth in Rule 2810.

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If you have any questions or comments, please contact the undersigned at (202) 728-8104, or Joseph E. Price, Vice President, Corporate Financing Department, Regulatory Policy and Oversight, at (240) 386-4642.

Sincerely,

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cc: Racquel Russell
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