NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
750 First Street N.E., Suite 1140
Washington, D.C. 20002
202/737-0900
Fax: 202/783-3571
www.nasaa.org

August 4, 2006

VIA EMAIL: rule-comments@sec.gov

Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Release No. 34-54118; File No. SR-NASD-2005-114 - Proposed Amendments to NASD Rule 2810 Relating to Compensation, Fees, Expenses, and Offering Practices for Direct Participation Programs ("DPPs") and Real Estate Investment Trusts ("REITs")

Dear Ms. Morris:

The Securities Division of Office of the Secretary of the Commonwealth of Massachusetts appreciates this opportunity to comment on the NASD's proposed revisions to its rules relating to compensation and sales practices for DPP offerings and REITs. These proposed changes were originally included in NASD Notice to Members NTM 04-07.

Introduction

DPP programs and non-exchange traded REITs (collectively "Investment Programs") are typically illiquid investments that involve some of the highest fees and greatest sponsor conflicts of interest of any products sold to retail investors. These characteristics make Investment Program offerings riskier than many other securities. Moreover, these programs present serious regulatory challenges, particularly relating to investor suitability, because they involve higher sales commissions and organizational and offering expenses than most other investments.

This letter will follow the descriptive summary in Part II of the Release.

The Massachusetts Securities Division strongly supports virtually all of the NASD's proposals included in the Release. In the case of sales contests, however, the Division urges the NASD to go further than modifying broker sales contests, and ban such contests altogether.

Purpose of Amendments

The Division is in accord with the NASD's determination that Rule 2810 should apply to both direct participation programs ("DPPs") and REITS, because those programs are functionally so similar, and because they present many of the same regulatory issues, especially relating to distribution costs, illiquidity, conflicts of interest, and sales practices.

a) Organization and Offering Expenses.

The NASD's rule changes make appropriate reforms to the selling and organizational and offering expense rules for these Investment Programs by making the rules more explicit and objective in their treatment of certain fees and expenses. Under the proposals, compensation payable to underwriters, broker-dealers, or affiliates may not exceed 10 percent of gross proceeds, regardless of the source from which it is derived. Total organization and offering expenses may not exceed 15% of gross offering proceeds, including any compensation and due diligence expenses.

i. Issuer Organizational and Offering Expenses

The selling fee and organization and offering expense caps are generous. The 10% limit on selling compensation allows for very high commissions compared to other products. The 15% limit on organization and offering expenses is also high, particularly when compared to the expenses charged in connection with other pooled investment vehicles, like mutual funds. The Division is concerned that, besides consuming investor dollars, these high expenses and commissions can promote aggressive sales tactics and unsuitable sales of these products.

The NASD takes an appropriately inclusive view of the expenses that should be included in the category of Organizational and Offering Expenses ("O&O expenses"), and therefore made subject to the 15% O&O cap. The O&O expenses listed by the NASD are integral to getting an Investment Program set up and sold. Those expenses include: (i) expenses, including overhead expenses, for assembling and mailing offering materials; processing subscription agreements and generating advertising and sales materials; (ii) legal services provided to the sponsor or issuer; and (iii) salaries and non-transaction-based compensation paid to employees or agents of the sponsor or issuer for performing such services. Also included would be expenses for transfer agents, escrow holders depositories, engineers and other experts, and registration and qualification of securities under federal and state law, including taxes and fees and NASD fees.

The Division believes that the NASD's approach to these expenses is correct; it would be inaccurate to exclude them from O&O. Moreover, allowing these expenses to be excluded from the definition of O&O could permit evasion of the cap.

ii. Limits on Compensation

The Division is in accord with the NASD's approach of applying the 10% compensation limit on compensation paid <u>from any source</u>. This wording is needed to capture the various types of compensation that may be paid in these programs, particularly in view of the large numbers of affiliated transactions and arrangements they involve. If the limitation were applied only to compensation paid directly from offering proceeds, that could create opportunities to evade the limitation.

iii. Dual Employees

The NASD correctly addresses the handling off compensation paid to "dual employees," who are involved in the retailing of these offerings, but who may also provide non-distribution related services to the sponsor. Certainly, payments to any employee whose compensation is contingent upon or will vary depending on how much money is raised or the amount of securities sold should be deemed underwriting compensation.

For smaller programs, with fewer than 10 people engaged in wholesaling, the NASD proposes to carry out an allocation between selling compensation payable to an employee and compensation payable for other duties. This may be a logical approach to regulating smaller sponsors. However, the Division urges the NASD to carefully analyze the work done by these employees and the payments made to them to ensure that they will not be paid selling compensation under some other label, thereby evading the 10% cap on selling compensation.

iv. Wholesaling

DPP and REIT offerings often involve significant wholesaling payments and fees. While the wholesaling process is a key step in the marketing of these products, that process is invisible to investors, and it is not well disclosed in program prospectuses. Clearly, wholesaling costs should be considered a type of underwriting compensation, and they should be subject to the cap on such compensation.

Wholesaling involves the creation of a large amount of "internal use" and "broker-dealer use only" advertising material. We believe that much of this material is not filed with any regulator. The internal use advertising that has been filed with the Division often describes these offerings in glowing terms, it is often not balanced –lacking risk disclosure or downplaying the risks of the investment, and it emphasizes the best ways to pitch the programs to customers. These pieces often put a strong emphasis on the high selling compensation the programs will pay. Moreover, in some cases, the Division has found that these pieces contain statements of projected return that are not in program prospectuses.

The Division urges the SEC, NASD, and other regulators to bring greater scrutiny to wholesaling activities. This scrutiny should include reviewing the ways that the sponsors contact brokerage personnel and should include reviewing marketing materials directed to brokerages and their employees.

v. Training and Education Meetings, Legal Services to Broker-Dealers Participating in the Offering, and Advertising and Sales Materials

The Division supports including these costs as forms of underwriting compensation. All of these costs relate to the sales and marketing of these products.

So-called training and education meetings have been a continuing source of regulatory violations. Despite past rulemaking, these meetings have been used as a kind of bonus compensation for salespersons. This is the wrong way to promote the sale of high fee, high risk, and illiquid offerings.

vi. Due Diligence

The Division agrees with the NASD's proposals relating to due diligence costs. For too long, Investment Program offerings have involved "due diligence allowances" of .5%, which appear to be used, at least in part for, marketing.

The Division strongly agrees with the NASD's position that mischaracterizing underwriting compensation as due diligence costs would violate NASD rules and the federal securities laws. Such mischaracterizations would also violate the anti-fraud provisions of the state securities laws.

The Division also agrees with the proposed rule change that would require that a member not accept any payments or reimbursements for due diligence expenses unless those costs are included in a detailed and itemized invoice.

b. Liquidity Disclosure

The Division strongly supports the proposal that a member selling an investment program must inform prospective investors whether the sponsor has offered prior programs for which the prospectus disclosed a date or time period when the program might be liquidated, and whether, in fact, the program actually liquidated on or around that time or time period. We note that in some cases it will not be in a sponsor's interest to liquidate a program, since affiliates of the sponsor typically receive ongoing fees from the program that will end when it is liquidated.

This proposal addresses a serious gap in the disclosure provided for these offerings. The illiquidity of these programs is one of the main sources of risk to investors, and often the risks of illiquidity and delayed liquidation are not well disclosed in prospectuses.

c. Sales Loads on Reinvested Dividends

The Division strongly agrees with the proposal to prohibit sales commissions on reinvested distributions. Since the reinvestment of distributions typically does not involve a separate investment decision by the investor who purchased the program, it is anomalous that commissions should be paid on such reinvestments. Also, in many investment programs (particularly REITs that propose to pay immediate distributions, even before they acquire properties.), the distributions will represent returns of invested capital, so charging commissions on reinvested distributions would result in double selling compensation.

d. Non-Cash Compensation Provisions

i. Location of Training Meetings

Non-cash compensation payable in connection with Investment Programs has been a source of serious regulatory violations. Many of the NASD's proposals are clearly intended to address problems that regulators have seen in this area.

The proposals require that a training meeting be held at a location appropriate to the purpose of the meeting (e.g., at the office of the member or the location of a significant or representative asset of the program). Nonetheless, the Division remains concerned that sponsors will try to turn the meetings into compensation by holding them in attractive locations. We ask the NASD to be vigilant that this will not happen.

The Division questions the need for any off-site training and education meetings for these products. The Division notes that many other categories of offerings, even complex ones, are marketed and sold without the kinds of “training and education meetings” that exist in the context of DPPs. Even at the time when these trips were a blatant kind of bonus for high producing brokers, the trips typically included at least some educational content. The Division remains concerned that offsite meetings will perpetuate past bad practices relating to these offerings.

ii. Sales Contests: Total Production and Equal Weighting Requirements

The NASD proposes to ban product-specific sales contests by requiring that any contests be based on a salesperson’s total production, and that all products should be equally weighted. While these proposals may diminish some of the problems posed by product-specific sales contests, the Division urges that sales contests of all kinds should be abolished.

There is a significant disclosure gap relating to contests. Investors typically are not aware of sales contests, and they are not told of the specific incentives payable to the salespeople with whom they deal.

Sales contests are precisely the wrong structure of compensation for selling securities. Contests create a strong incentive simply to sell, irrespective of the needs of the customer. Contests create incentives that are directly contrary to the obligations that broker-dealers and agents have to their customers, particularly the obligation of fair dealing and the obligation to ensure that sales are suitable for customers. In view of these fundamental problems with sales contests, the Division urges the NASD and SEC to take immediate steps to abolish them.

The Massachusetts Securities Division appreciates this opportunity to comment on these important rules. If you have any questions about this letter or we can assist in any way, please contact me at (617) 727-3548.

Sincerely,

Bryan Lantagne
Director, Massachusetts Securities Division