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Federated
WORLD-CLASS INVESTMENT MANAGER®

November 5, 2010

Ms. Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File No. S7-15-10
Mutual Fund Distribution Fees

Dear Ms. Murphy:

This letter presents the comments of Federated Investors, Inc. and its subsidiaries ("Federated") on the recent release by the Securities and Exchange Commission ("SEC," or "Commission") proposing, and seeking comments on, major changes in the regulation of payments by open-end management investment companies ("mutual funds") to support the distribution of their shares.[1] Federated is one of the largest investment management firms in the United States, managing $341.3 billion in assets as of September 30, 2010. With 134 funds and a variety of separately managed account options, Federated provides comprehensive investment management to approximately 5,200 institutions and intermediaries including corporations, government entities, insurance companies, foundations and endowments, banks and broker/dealers.

Although initially opposed to Rule 12b-1,[2] after the rule's adoption Federated followed the rest of the mutual fund industry in incorporating the new rule into its distribution practices. Rule 12b-1 Plans now form an integral part of Federated's distribution program, with 175 out of 300 share classes having plans that provide for fees ranging from 5 to 75 basis points. Like other fund complexes that rely primarily on intermediaries for distribution, Federated uses nearly all of these fees to pay intermediaries. Unlike some other fund companies, Federated does not treat fees for personal service and the maintenance of shareholder accounts (what NASD Conduct Rule 2830 defines as a "service fees") as part of their Rule 12b-1 fees, as these services are provided only after shares have been distributed and the payments are not intended to encourage continued promotion of the shares.

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[1] The amendments were published for comment in Release No. IC-29367, Mutual Fund Distribution Fees; Confirmations, 75 Fed. Reg. 47064 (August 4, 2010) (the "Proposing Release").

[2] Unless otherwise indicated, any rule referred to in this comment letter is promulgated under the Investment Company Act of 1940 (as amended, the "1940 Act").

Given the critical importance of Rule 12b-1 to the continued strength and growth of the Federated complex, Federated joins in the reservations and concerns regarding the proposed regulations expressed in the Investment Company Institute's ("ICI") comment letter on the Proposing Release. In addition to the concerns addressed below, Federated would particularly note its agreement with the ICI's recommendations not to include any board guidance and to limit any additional disclosure required in the confirmation. Federated believes that directors and trustees will find the proposed board guidance more confusing than helpful. It is also important that the confirmation retain its function of documenting an investor's transaction with the broker/dealer, and not become a dumping ground for extraneous disclosure.

Federated is writing separately, however, to comment on those aspects of the proposal that could (1) be viewed as attempt to regulate activities beyond the ambit of Section 12(b) of the 1940 Act, (2) curtail the provision of services that are clearly beneficial to shareholders or (3) impose significant costs on the mutual fund industry without any likelihood of providing a corresponding benefit to shareholders. In particular, if the Commission decides to go forward with this proposal, Federated urges the Commission to make it clear in the adopting release that Rules 12b-2 and 6c-10 do not limit a mutual fund's ability to pay for non-distribution services provided by an intermediary to the fund or a class of its shareholders. The Commission also should recognize that the benefits of the automatic conversion proposed in Rule 6c-10 will diminish, and the cost of tracking shares for conversion will increase, directly with the length of the conversion period. One implication of this cost/benefit relationship is that there is no reasonably expected benefit that could justify the cost of mandating the eventual conversion of shares with rapid turnover and low fund level sales charges, such as shares designed for cash sweep programs.

I. PROPOSED RULE 12B-2 SHOULD NOT LIMIT THE ABILITY OF MUTUAL FUNDS TO PAY FOR LEGITIMATE POST-DISTRIBUTION SERVICES

The Proposing Release properly recognizes "that funds need not rely on proposed rule 12b–2 to charge expenses that can clearly be identified as not distribution related (*e.g.*, sub-transfer agency fees), [and that] funds could instead characterize those expenses as administrative expenses and thus keep total asset-based distribution fees within the 25 basis point limit of the marketing and service fee."[3] Any regulation adopted under Section 12(b) of the 1940 Act must be so limited, because the provision only authorizes regulation of a mutual fund's ability "to act as a distributor of securities of which it is the issuer, except through an underwriter." Thus, any activity that is not tantamount to a mutual fund acting as a distributor of its shares falls outside the ambit of Section 12(b) and any corresponding regulations.

[3] Proposing Release, 75 Fed. Reg. at 47075 n. 153, *citing* Investment Company Act Release No. 16431, Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, 53 Fed. Reg. 23258, 23271 n. 126 (June 21, 1988) ("[T]o the extent a fund is paying for legitimate non-distribution services, such payments need not be made under a 12b–1 plan, even if the recipient of the payments is also involved in the distribution of fund shares.").

The Proposing Release does not define what may constitute the "administrative expenses" that mutual funds need not include in the proposed marketing and service fee. Instead, the Proposing Release cites an NASD Q&A interpreting what services are not included in "Service Fees" for purposes of Conduct Rule 2830,[4] which provided that:

> In broad categories the term does not include subtransfer agency services, subaccounting services, or administrative services. Specific services not covered by the term "service fee" include:
>
> - Transfer agent and subtransfer agent services for beneficial owners of the fund shares.
> - Aggregating and processing purchase and redemption orders.
> - Providing beneficial owners with statements showing their positions in the investment companies.
> - Processing dividend payments.
> - Providing subaccounting services for fund shares held beneficially.
> - Forwarding shareholder communications, such as proxies, shareholder reports, dividend and tax notices, and updating prospectuses to beneficial owners.
> - Receiving, tabulating, and transmitting proxies executed by beneficial owners.

While this is an impressive list of services, Federated is concerned that the reference to the NASD Q&A may be construed as all-inclusive. More significantly, Federated is concerned that the references to "services fees" in proposed Rule 12b-2 could be construed to limit the authority of a mutual fund's board of directors or trustees to determine that "payments by an investment company for personal service and/or the maintenance of shareholder accounts" are

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[4] NASD Notice to Members 93–12 (1993) **Question #17**: What does the term "service fees" include or exclude?

> **Answer:** The term "service fees" is defined in subparagraph (b)(9) of the amended Rules to mean "payments by an investment company for personal service and/or the maintenance of shareholder accounts." As noted in the explanatory section of *NASD Notices to Members 90-56* (September 1990), the term "service fees" is not intended to include transfer agent, custodian, or similar fees paid by funds. In addition, the phrase is not intended to include charges for the maintenance of records, record-keeping, and related costs. *Notices to Members 92-41* (August 1992) states that "service fees are intended to be distinguished from other fees as a payment for personal service provided to the customer. It is essentially intended to compensate members for shareholder liaison services they provide, such as, responding to customer inquiries and providing information on their investments. It is not intended to apply to fees paid to a transfer agent for performing shareholder services pursuant to its transfer agent agreement. This fee does not include recordkeeping charges, accounting expenses, transfer costs, or custodian fees." Finally, the fact that a fund pays a fee pursuant to a "shareholder servicing" or similarly described plan does not conclusively determine whether the fee or any portion thereof constitutes a "service fee" for purposes of the Rules. [Footnotes omitted]

not primarily related to distribution. Any list of services in the adopting release should be accompanied by a confirmation that such list is not intended to be exhaustive.

A. Mutual Fund Boards Should Retain Authority to Determine that Service Fees Are Not Distribution Related

The inclusion of "service fees" in proposed Rule 12b-2 appears to be based on an "understand[ing] that funds continue to include 'service fees' [as defined in Conduct Rule 2830] as distribution expenses under rule 12b–1."[5] Not all funds follow this practice, however. After the Commission clarified that defensive 12b-1 Plans were not needed for non-distribution related expenses,[6] Federated and several other fund complexes implemented shareholder service arrangements outside of their Rule 12b-1 Plans. Federated does not view shareholder services as primarily related to a fund's distribution, insofar as the services are provided to existing shareholders and are not intended to promote further investments. While the SEC has taken the position that Rule 12b-1, as originally proposed and adopted, permits the use of fund assets to counteract redemptions as well as to promote distribution, it should be self-evident that not all activities tending to reduce redemptions, such as providing good service or excellent performance, should be characterized as distribution related and subject to Rule 12b-1 or proposed Rule 12b-2.

The fact that many other funds choose to pay service fees from their Rule 12b-1 Plans does not suggest that service fees are necessarily related to distribution. As noted in the Proposing Release, "Because a fund with a Rule 12b–1 plan is expressly permitted to pay for distribution services, it is not critical to determine whether a particular service it pays for in connection with [a service fee] is or is not for distribution."[7] In other words, because Rule 12b-1 does not itself limit the amount that a mutual fund may pay under plan, funds can eliminate any risk that payments to an intermediary might be determined to have been related to distribution by setting their Rule 12b-1 Plans at the maximum amount permitted under Conduct Rule 2830 and making all such payments under the Rule 12b-1 Plan, even if they believe that some of the payments are not distribution related.[8] As the Proposing Release notes, some funds even pay for subtransfer agency services, subaccounting services, or administrative services out of their Rule 12b-1 Plans,[9] but this does not prevent the Commission from acknowledging that these are not distribution related expenses.

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[5] Proposing Release, 75 Fed. Reg. at 47071 n. 100.

[6] *See*, Release No. 16431, *supra*, note 3.

[7] Proposing Release, 75 Fed. Reg. at 47075, n. 153, *quoting* Martin G. Byrne, *The Payment of Fund Supermarket Fees by Investment Companies*, 3 Investment Lawyer 2 (1996)

[8] Federated sells shares to certain fiduciaries who cannot receive compensation for purchasing shares on behalf of their clients, so it is important for Federated's funds to pay service fees outside of their Rule 12b-1 Plan to avoid any implication that the fees are paid for distributing the shares. Other fund complexes do not sell their shares to these types of fiduciaries, and, presumably, would not have any reason to exclude service fees from their plans.

[9] Proposing Release, 75 Fed. Reg. at 47099.

Treating service fees as not related to distribution is also consistent with other securities regulations. For example, Rule 721(a)(4)(i)(E) under the Securities Exchange Act of 1934 includes fees paid "[i]n connection with an investment in shares of an investment company for personal service [and] the maintenance of shareholder accounts" among the "administration fees" that count towards a bank's relationship compensation for purposes of determining whether the bank is chiefly compensated for its fiduciary services, rather than for effecting trades. Congress also excluded from this definition of "broker" banks that engage in sweep transactions in no-load money market funds, knowing that under FINRA regulations, a no-load fund could pay the bank up to 25 basis points of service fees. Thus, the regulations intended to require SEC supervision of those receiving compensation for effecting securities transactions uniformly treat service fees as something other than sales compensation.

The Proposing Release speculates that funds may include service fees in their Rule 12b-1 Plans because service fees may serve as an inducement to sell the fund's shares. This same argument can be made, however, with respect to fees for any post-distribution services provided by an intermediary (or its affiliated persons) to funds or their shareholders, including the subtransfer agency services, subaccounting services, or administrative services that the Commission has acknowledged are not distribution related services. It is a tautology to observe that an intermediary cannot earn fees for post-distribution services unless shares are first sold to its clients. The Commission therefore cannot use the potential inducement of post-distribution fees to differentiate between fees that are primarily related to distribution and those that are not.

Federated therefore urges the Commission to clearly provide that a service fee paid by a mutual fund would not count towards Rule 12b-2's 25 basis point limit to the extent that a mutual fund's board of directors determines that the service fee is not distribution related. This will assure that service fees are treated consistently with administrative fees and fees for other legitimate post-distribution services, and that the rule does not purport to regulate activities beyond the ambit of Section 12(b).

B. Mutual Fund Boards Should Retain Authority to Pay for Services in Addition to those Identified in the NASD Q&A

Although the Proposing Release does not indicate that "administrative expenses" are the only non-distribution related expenses that may be paid for by a mutual fund, the release also does not expressly recognize the existence of other classes of expenses. This may inadvertently lead to a presumption that such expenses are distribution related. Federated is primarily concerned with maintaining a mutual fund's ability to pay for two common services: sweeping cash balances into money market funds and administering retirement plans.

Several Federated money market funds have classes designed for use by brokers or banks as investments for their clients' cash balances. The compensation paid by these classes have several components that correspond to the separate and distinct services provided by the sweep provider: a fee paid under the fund's Rule 12b-1 Plan for distributing the shares through the sweep program; a fee for recordkeeping and related services; and a fee for shareholder services. This is the same combination of fees that might be paid to any intermediary who distributes the fund's shares through an omnibus account. Broker and banks with sweep programs provide an additional service, however, through their sweep systems. These sophisticated systems

automatically monitor the client's account activity to determine whether cash needs to be moved into or out of the account, add the corresponding order to the omnibus account's daily trading, debit or credit the cash from the client's account and reconcile the activity. This service is provided uniformly to all sweep clients and warrants some compensation beyond what is paid to intermediaries who do not provide sweep investments to their clients. The additional compensation would be for the service provided to the shareholders, however, and not for distributing the fund's shares.

Retirement plan recordkeepers may also provide services beyond those provided by other intermediaries with omnibus accounts. For example, they must manage periodic deductions from participants' paychecks, allocate the deductions on a percentage basis among participants' investment selections and translate the allocations into dollars and shares in order to transmit the aggregate orders to the funds' transfer agents. As retirement plans periodically change investment options, plan administrators also must manage and reconcile the wholesale conversion of participant accounts from one fund to another. All of these activities must conform to the exacting requirements of ERISA, which require additional compliance oversight, documentation and recordkeeping. These additional activities, which are not distribution related, may also warrant additional compensation.

While banks, brokers and retirement plan administrators could charge clients directly for these services, it is often more efficient (from both an operational and tax perspective) for the fund to pay for the services. These intermediaries may in fact prefer to use a class of shares that provides for this additional compensation, rather than developing systems for assessing individual account charges. Federated believes that mutual fund directors should maintain the flexibility to establish share classes that are reasonably designed to compensate intermediaries for these and similar services that would clearly and uniformly benefit the shareholders in the class. A statement to this effect in any adopting releases would assure that Rule 12b-2 does not cause directors to become unduly cautious when considering share classes with innovative compensation structures.

II. THE COMMISSION SHOULD NOT REQUIRE A MANDATORY CONVERSION OF SHARES SUBJECT TO FUND LEVEL SALES CHARGES, OR SHOULD EXCLUDE CLASSES OF SHARES THAT HAVE ONLY A REMOTE CHANCE OF BEING HELD TO THEIR CONVERSION DATE

One of the most expensive elements of the Commission's proposal is the requirement to convert shares with a fund level sales charge into a class of shares without such a charge after a specified period. Although the Commission correctly observes that funds have already built systems for the conversion of Class B Shares, these systems (which are designed to track reductions in CDSCs) will need to be modified for other share classes. In addition to the initial programming expenses, transfer agents and intermediaries will charge funds ongoing fees to track and convert shares. Assuming that they charge the same amount for tracking fund level sales charges as they currently charge for tracking CDSCs,[10] Federated estimates that transfer

[10] The Federated fund's transfer agent charges an additional $1.32 per account per year to track the aging of shares, and intermediaries typically charge an additional $3.00 per account per year.

agent costs for Federated's mutual funds will increase by over $270,000 per year, and that annual intermediary charges to Federated's funds could increase by well over $6 million.

The cost of tracking and converting shares will benefit shareholders, however, only if they continue to hold their shares after the conversion date. If a shareholder redeems shares prior to the conversion date, then tracking the mandatory conversion date will not limit the amount of fund level sales charges. Even if the shareholder holds shares past the conversion date, the benefit will only accrue at the rate of the fund level shares charge. The lower the fund level sales charge, the longer the conversion period and the longer it takes for significant benefits to accrue after conversion.

A. Class C Data Suggests that Most Shareholders Will Not Hold Their Shares to the Mandatory Conversion Date

Federated's experience with Class C Shares suggest that the benefits of the proposed mandatory conversion may never equal the costs, even for funds that charge the maximum amount permitted by Conduct Rule 2830. Federated has offered Class C Shares for seventeen years and, during that time, none of the classes have reached the limit impose by Conduct Rule 2830. Although the Conduct Rule 2830 limit applies to the entire class and not to each shareholder, Federated's experience shows that, on average, Class C investors would not hold their shares to the end of the conversion period that proposed Rule 6c-10 would require.

Federated currently has 44 mutual funds offering Class C shares. The weighted average holding period for these shares is just over 40 months, well less than half of the 88-month conversion period that proposed Rule 6c-10 would require for shares subject to the highest load paid on the corresponding Class A shares. Only one fund approaches this limit, with an average holding period of less than 84 months. The next closest fund has a holding period of less than 58 months, and the median fund average is less than 40 months. These statistics strongly suggest that investors holding shares for the entire 7 plus year conversion period will be rare exceptions, rather the rule. Only these few investors will obtain any benefit from the mandatory conversion.

This question is susceptible to a more complete analysis than Federated can provide in this comment letter. Federated therefore recommends that the Commission gather the data necessary to determine the average holding period of shares subject to Rule 12b-1 Plans, the distribution of such holding periods, and the costs incurred by funds in tracking shares for conversion and in maintaining a no-fund level sales charge class that will probably have low account balances.[11] This will allow the Commissions staff to prepare an accurate cost benefit analysis of the conversion requirement.

[11] Although funds that have a class that charges only a front-end sales load and a marketing and distribution fee (such as most Class A shares) could use this class for purposes of conversion, few money market funds with Rule 12b-1 plans have such a class. Funds intended for distribution to retirement plans or institutional investors also may not have a preexisting class into which to convert shares.

B. Rule 6c-10 Should Exclude Funds with Low Fund Level Sales Charges or High Turnover from the Mandatory Conversion Requirement

Even if the Commission's analysis results in a demonstrable benefit to Class C shareholders, it is clear that requiring conversion of classes of shares with higher redemption rates and lower fund level sales charges will produce diminishing benefits at increased costs. The lower the fund level sales charge, the longer the conversion period and the longer shareholders must hold shares before they materially benefit from the conversion. The higher the redemption rate, the less likely shareholders will be to hold shares to the conversion period. Frequent share activity and extended tracking periods will also increase the cost of the conversion requirement. At some point, the cost and benefit lines must cross, and mandatory conversion of shares can no longer be justified.

This should be true of classes with fund level sales charges of 25 basis points or less. Under proposed Rule 6c-10, these shares would not convert until 24 years after their purchase (assuming the fund bases the conversion on the maximum sales charges permitted by Conduct Rule 2830). Even for the loyal investor who holds shares for such an extended period, the present value of any eventual benefit (which will also accrue at only 25 basis points a year after the conversion date) would be nominal. Given that Federated's money market funds alone are estimated to incur an additional $6 million a year in charges from intermediaries for tracking the aging of shares, there cannot be any justification for requiring funds to track their shares for nearly a quarter century.

It also should be appropriate to exclude funds that are designed to have higher turnover in their shares. Money market funds, for example, are designed to provide liquidity and therefore experience regular redemptions from shareholders. Using ICI data, Federated has determined that the average holding period for money fund shares (determined on a first in/first out basis) has ranged from two to four months over the past decade. Few investors are likely to acquire money fund shares and hold them continuously for eight or more years. Therefore, money market funds would be logical candidates for exclusion from the mandatory conversion requirement of Rule 6c-10 (unless the money market fund is used as an exchange option for other funds, in which case it any period during which the money market fund is held should be added to the conversion period of any exchanged shares).

Although Federated recognizes the importance of treating sales charges in a uniform manner, permitting funds to forgo tracking shares for conversions if the conversion period exceeds ten or twelve years or if the fund is intended to be held for a period shorter than the conversion date would clearly be justified on a cost/benefit basis. Because a low fund level sales charge paid over an extended period of time should have a lower present value than a front end sales load, intermediaries are unlikely to view classes with unlimited low sales charges as offering higher sales compensation than other classes. Similarly, the expected compensation for funds with short holding periods will be the same regardless of whether conversions are mandated, so their exclusion would not change an intermediary's incentive to sell such funds. In summary, limiting the conversion requirement based on the rate of fund level sales charges and expected redemptions should be fully justified by any reasonable cost benefit analysis, and would not create an arbitrary distinction in how much intermediaries can receive for selling different classes of shares.

III. CONCLUSION

While it may be important for shareholders to understand the extent to which mutual funds are paying their intermediaries for distribution activities, and to subject all forms of compensation for such activities to the same limitations, the Commission cannot adopt regulations in a manner that (a) restricts a mutual fund's ability to pay for other legitimate services provided to the fund or its shareholders or (b) would require mutual funds to incur expenses in excess of any reasonably expected benefit to their shareholders. As proposed, Rule 12b-2 runs the risk of unduly restricting a mutual fund's ability to pay for legitimate non-distribution services by creating a presumption that post-distribution service fees are distribution related unless they are for the type of services already excluded from the limitations of Conduct Rule 2830. Moreover, the mandatory conversion requirement of proposed Rule 6c-10 is likely to result in costs to mutual funds well in excess of any anticipated reduction in fund level sales charges due to the required conversions.

If the Commission decides to adopt the proposed reforms, it should therefore, at a minimum: (1) limit Rule 12b-2 to actual distribution and marketing expenses, while acknowledging that a mutual fund's board of directors has authority to authorize payments for post-distribution services (including service fees) and other legitimate non-distribution services (such as cash sweep services and retirement plan administration) without limitation under Section 12(b), and (2) either not require any mandatory conversion of shares subject to a fund level sales charge, or else require such a conversion only when the conversion period is less than a reasonable number of years (*e.g.*, ten years). In addition, the Commission should exempt money market funds from the mandatory conversion requirement due to their nature as short-term investments that will rarely be held to the end of any reasonable conversion period.

Please feel free to contact us if you have any questions or require additional information relating to our comments.

Yours very truly,

/s/ John W. McGonigle

John W. McGonigle
Executive Vice President and Chief Legal Officer