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Federated
WORLD-CLASS INVESTMENT MANAGER®

May 10, 2004

Mr. Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0609

Re: Prohibition on the Use of Brokerage Commissions to Finance Distribution File No. S7-09-04

Dear Mr. Katz:

This letter presents the comments of Federated Investors, Inc. ("Federated")[1] regarding the proposal of the Securities and Exchange Commission ("Commission") to adopt amendments to Rule 12b-1, promulgated under Section 12(b) of the the Investment Company Act of 1940 (the "Act"), to prohibit the direction of mutual fund brokerage commissions compensate for the sale of mutual fund shares.[2] Federated is writing primarily to address the broad questions regarding Rule 12b-1 posed at the end of the Release. With regard to the proposed amendment to prohibit "directed brokerage," we support the proposal and the comments made by Investment Committee Institute (the "ICI") in its letter. However, in this regard, Federated would like to emphasize the need to regulate broker/dealers as well as mutual funds and their investment advisers. While an adviser's interest in promoting sales of its funds may conflict with the funds' interest in best execution of their trades, a broker's interest in promoting its brokerage services may also conflict with its clients' interest in selecting a suitable mutual fund. Thus, a potentially "unmanageable" conflict exists on both sides of a directed brokerage arrangement, requiring equally vigorous regulation of both parties.

Federated therefore urges the Commission to approve the NASD's proposed amendments to Conduct Rule 2830(k) (the "Anti-Reciprocal Rule") contemporaneously with the Commission's amendments to Rule 12b-1. We also recommend that the revised Anti-Reciprocal Rule have a provision for broker/dealers similar to proposed paragraph (i) of Rule 12b-1. In our experience, broker/dealers generally separate their trading functions for institutional clients, such as mutual funds, so that different representatives deal in equities, bonds and derivatives. Yet another group of representatives within the broker/dealer typically handles sales of mutual fund shares. Consequently, our portfolio traders rarely deal with broker/dealer representatives who sell mutual funds. Under these circumstances, it should be possible for broker/dealers to maintain separation between representatives responsible for selling mutual funds and representatives that trade with such funds, so that one group does not influence the other.

[1] Federated is one of the largest asset management and mutual fund firms in the United States. Through its subsidiaries, Federated manages total assets of more than $193 billion and serves as adviser, subadviser, distributor, and/or administrator for over 135 mutual funds, as of March 31, 2004.
[2] The proposal is set forth in Investment Company Act Release No. 26356, 69 FED. REG. 9726 (Mar. 1, 2004) (the "Release").

Regarding the broader issues raise by the Release, the Commission stated, "one approach on which we would particularly like to receive comment would refashion Rule 12b-1 to provide that funds deduct distribution-related costs directly from shareholder accounts rather than from fund assets."[3] This approach would effectively limit investors to two alternatives: they may pay their load either up-front or over time. It is not clear if this approach would permit the use of fund assets to pay for other distribution related expenses (such as advertisements). The Release asserts that this approach would have the following advantages:

- it would increase "transparency;"
- "existing shareholders would not pay the costs of selling to new fund shareholders;"
- the share of 12b-1 fees borne by "long-term shareholders" would no longer "exceed their fair share of distribution costs;"
- it "would help to eliminate the substantial conflicts of interest presented by the use of fund assets to pay for distribution," freeing the board of directors to focus on other matters; and
- it "also could simplify investing in funds and eliminate many of the problems with fund sales practices [the Commission sees] today."

Federated was one of two investment managers that opposed the adoption of Rule 12b-1 in 1980.[4] If it were still 1980, Federated would still recommend that the Commission permit investment managers to fashion their own means of promoting the distribution of their funds. However, by adopting Rule 12b-1 and permitting the development of multiple classes of shares, the Commission laid the foundation for nearly a quarter century of innovation and development by the industry. We cannot understand how restructuring the entire industry overnight through the elimination of multi-class funds would serve investor interests. This egg is not merely scrambled, it has been cooked, eaten and absorbed into the very morrow of the industry. [5]

The purported advantages cited in support of this approach concern us particularly. The Release seems to imply that the principal offense committed by the industry under Rule 12b-1 has been to give shareholders choices, in the form of different classes of shares. Choices require more explanation, increase complexity and can lead to confusion. Nevertheless, we maintain that the degree of choice available to consumers is an important measure of the health of a market. The use of Rule 12b-1 to create alternative means for shareholders to compensate intermediaries is an aspect of a healthy competitive industry, not an illness requiring drastic remedies.

We are also troubled by the assertions that all Rule 12b-1 Plans require existing shareholders to subsidize sales to future shareholders, place an "unfair" burden on long-term shareholders and create irreconcilable conflicts of interest. Funds use 12b-1 fees in a variety of ways, many of which do not raise any of these concerns. For purpose of this letter, we will focus pri-

[3] Release at 9731.
[4] Investment Company Act Release No. 11414, *Bearing of Distribution Expenses By Mutual Funds*, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶82,678, n. 8 (Oct. 28, 1980).
[5] We assume that the Commission would adopt a forward-looking rule, as we are not aware of any authority that would permit mutual funds to retroactively assess their shareholders for payments to intermediaries. However, even a forward-looking rule would only compound any confusion that shareholders currently suffer regarding the distribution charges levied on their holdings.

marily on 12b-1 fees that funds use to compensate intermediaries. Such Plans underlie both Class B and Class C shares. Class B shares typically use a 12b-1 fee to repay a commission advanced by the mutual fund's principal underwriter to the shareholder's intermediary. Class B shares also impose a contingent deferred sales charge (a "CDSC") at redemption, to recover any advances not repaid by the 12b-1 fees. Class C shares typically pay the shareholder's intermediary a "level load," equal to a percentage of the average value of the shareholder's account.[6]

Both Class B and Class C shares provide an alternative to payment of traditional "front-end loads" (typically designated as a Class A shares), thereby increasing the choices available to investors. In each case, all 12b-1 fees are used to compensate (or repay compensation advanced to) intermediaries of *existing* shareholders. Although the 12b-1 fees paid to an intermediary cannot be traced directly to a particular shareholder, the share of 12b-1 fees borne by each shareholder is in direct proportion to payments made to that shareholder's intermediary. As a result, each shareholder compensates her intermediary for services already received by paying 12b-1 fees over time, without subsidizing any other shareholder. In such cases, the 12b-1 fee is no different from the payment of a traditional front-end load by the shareholder, apart from the time over which the 12b-1 fee is paid.

With respect to equitable treatment of shareholders, the declining CDSC on Class B shares results in roughly equal payments by short and long-term shareholders. Generally, the CDSC on a Class B share is reduced annually by at least the amount of the 12b-1 fees (other than service fees), so that shareholders pay approximately the same amount regardless of when they redeem their shares.[7] In addition, as the Release observes,[8] Class B shares limit the shareholder's total fees by converting into a lower expense class (usually Class A shares), typically within a year after the CDSC expires.

In contrast, Class C shareholders pay more 12b-1 fees the longer they hold their shares. However, this may be a cheaper alternative than Class A or Class B shares, particularly if the shareholder wants the flexibility to trade among mutual funds in different families, without having to pay a front or back-end load every time the shareholder moves to a different fund. Class C shares also reduce the intermediary's incentive to "churn" mutual funds in order to earn additional commissions. In any event, a Rule 12b-1 Plan for Class C shares treats all shareholders equally, so any variations in payments by different shareholders should not be regarded as "unfair."

Finally, neither Class B nor Class C shares create any true conflicts of interest. Purchasers of Class B and Class C shares make an implied agreement to pay for their intermediaries' services over time.[9] Termination of a 12b-1 fee supporting Class B or Class C shares would give shareholders' the benefit of their intermediaries' services without paying for them. This is

[6] Not so many years ago, the Commission expressed interest in promoting such asset-based fee arrangements. *See* Investment Advisers Act Release No. 1845, *Certain Broker/Dealers Deemed Not To Be Investment Advisers*, [1999-2000 Transfer Binder] FED. SEC. L. REP. (CCH) ¶86,220 (Nov. 04, 1999) ("these new programs promise to benefit broker/dealer customers by aligning their interests more closely with those of the brokerage firm and its registered representatives").

[7] Changes in the shares' net asset value and the timing of the redemption (in terms of proximity to a reduction in the CDSC) will result in variations in the amounts actually paid by different Class B shareholders. Such variations result from the inherent uncertainty of future performance and operational limitations on the tracking of different CDSCs. They do not reflect an effort to treat long-term shareholders "unfairly."

[8] Release at 9732, n. 66.

[9] This agreement will become more explicit if the Commission adopts the point-of-sale disclosure proposed in Release No. 34-49148, *Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds; Proposed Rule*, 69 FED. REG. 6438 (Feb. 10, 2004).

not a legitimate consideration for mutual fund directors voting to renew a 12b-1 fee. We simply cannot see how disclosed 12b-1 fees used to compensate a shareholder's intermediary for services already rendered can ever be contrary to the shareholder's interest.

At bottom, the purported "advantages" of assessing fees on shareholders' accounts are merely reformulations of criticisms levied by self-professed advocates of sweeping industry reform. Federated believes that these criticisms are fundamentally at odds with both business realities and shareholder interest. It is a fact of life that the distribution of mutual funds costs money. Inevitably, one can trace in some fashion money paid for distribution to assets of mutual fund shareholders, either before or after the shareholders invest those assets in mutual funds. Yet reformers would prohibit a mutual fund from paying for distribution costs directly through 12b-1 fees or indirectly through the adviser's use of fees earned for services it rendered to the fund. The logical implication of this critique is that front-end loads should be the only means of paying for mutual fund distribution. Yet the reformers do not explain why shareholders should prefer to pay front-end loads, rather than 12b-1 fees, to cover distribution costs. Nor do they explain how it is in the interests of shareholders to concentrate distribution activities entirely in the hands of intermediaries, who are completely unsupervised by the mutual fund's directors and who have no continuing stake in the fund's performance. Most significantly, these reformers fail to acknowledge that, taken to its logical conclusion, their reasoning would abolish the very no-load funds that, in other contexts, they hold out as models for the industry.[10]

Moreover, the Commission's proposed alternative has already been adopted and found wanting. As the Release notes, mutual funds can already charge "installment loads" under Rule 6c-10. Yet, Federated has not experienced *any* competition from mutual funds using this form of sales compensation. If shareholders preferred account level installment payments, we would expect to see some funds touting this method to attract investments. We suspect that the numerous problems outlined in the ICI's comment letter account for the lack of interest in this method of sales compensation. We cannot fathom the wisdom of forcing the industry to use a method that scarcely anyone has chosen to use voluntarily.

Notwithstanding our defense of the existing rule, Federated acknowledges that Rule 12b-1 suffers from two related, deep seated, conceptual flaws. First, the rule focuses on whether an activity is "primarily *intended* to result in the sale of shares issued by [the investment] company." Federated believes that fund shareholders are more concerned with what their fund's money is used for than the intent behind its use. More importantly, the standard is unduly broad and vague. The Commission cannot be surprised to learn that most activities engaged in by organizations whose primary business is the sale of mutual fund shares are intended to have this result. This fact accounts for the tremendous range of activities now financed by 12b-1 fees, some of which are not self-evidently distribution related. It has also led to the adoption of so-called "defensive plans" to prevent inadvertent violations of the rule. Defensive plans also relieve fund boards from the unenviable (and sometimes impossible) task of discerning the "primary" intent motivating complex business decisions.

The second flaw is notion that a fund's advisory fee can ever be a "disguised 12b-1 fee." Federated has never understood the Commission's "logic" on this point. The Commission's premise appears to be that any use of advisory fees to promote the sale of a mutual fund violates section 12(b), because the fund pays the advisory fee and, therefore, pays indirectly for the pro-

[10] We cannot help but note that Vanguard, often lauded as the paragon of mutual funds by critics of our industry, was the first fund complex to obtain an exemption from section 12(b) permitting their funds to pay for distribution costs. Investment Company Act Release No. 9927, *In the Matter of The Vanguard Group, Inc.* (Sep. 13, 1977). The hearings into Vanguard's application ultimately spawned Rule 12b-1.

motion of its sales. This premise flies in the face of economic reality, however, because investment advisers (like all other businesses) must promote their products (in this case mutual funds) to compete and grow. We cannot believe that Congress, in enacting section 12(b), intended for the Commission to isolate investment advisers of mutual funds and prohibit them from engaging in promotional activities vital to their success. Without an opportunity to increase sales of their mutual funds, higher fees would be the only means left for mutual fund managers to increase their revenues, which clearly conflicts with one of the basic objectives of the Act. We contend that a more logical understanding of section 12(b) is that the use of a fee lawfully paid to an adviser (or other service provider) is not a concern of the fund or its shareholders.

Federated therefore recommends that the Commission consider further amendments to Rule 12b-1 that would remedy these flaws and provide clear, direct and workable guidance to funds, their boards, shareholders and service providers. To accomplish this, we would advise the Commission to consider the language and intent of section 12(b) of the Act. Section 12(b) permits the Commission to regulate—not prohibit—when a fund "may act as distributor of securities of which it is the issuer." This section "was intended to protect funds from bearing *excessive* sales and promotion expenses."[11] The Commission should seriously consider what constitutes "excessive sales and promotion expenses" and what safeguards it should impose to prevent them. In considering this question, the Commission should review the NASD's limitation of "asset based sales charges" (including 12b-1 fees), pursuant to the NASD's authority to protect against "excessive sales loads" under section 22(b) of the Act. Perhaps the Commission will find that it should modify Rule 12b-1 so that it complements the excessive compensation limits of Conduct Rule 2830(d), just as the proposed amendments prohibiting "directed brokerage" will compliment Conduct Rule 2830(k). Regardless, the result will surely be an improvement over amendments seeking to *deter* sales and promotion expenses by making them harder to administer and taking choices (*i.e.*, classes of shares) away from shareholders.

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Federated very much appreciates having the opportunity to comment on this Release. If you would like to discuss these comments with us, please contact the undersigned. Thank you very much.

Cordially,

/s/ Stephen A. Keen
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cc: John W. McGonigle, Federated Investors, Inc.
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[11] Release at 9727 (emphasis added).