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April 6, 2006

Ms. Nancy Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-0903

Re: S7-06-06, Mutual Fund Redemption Fees; Proposed Amendments to Rule 22c-2

Dear Ms. Morris:

This letter presents the comments of Federated Investors, Inc. and its subsidiaries ("Federated")[1] on the recent proposals by the Securities and Exchange Commission ("SEC," or "Commission") to amend rule 22c-2 ("Rule") under the Investment Company Act of 1940 ("ICA").[2] As noted in the Release, the Proposals are intended to (i) limit the types of intermediaries with which funds must negotiate "shareholder information agreements," (ii) address the Rule's application when there are "chains of intermediaries," and (iii) clarify the effect of a fund's failure to obtain an agreement with any of its intermediaries.

Federated is taking this opportunity to comment primarily with respect to the effect of a fund's failure to comply with any of the Rule's requirements (not just the failure to obtain the requisite agreement with a particular intermediary). We also urge the Commission to extend the date for compliance with the amendments beyond the current deadline of October 16, 2006, in order to provide sufficient time for funds to take necessary actions.

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[1] Federated Investors, Inc. is one of the largest investment management firms in the United States, managing $213 billion in assets as of Dec. 31, 2005. With 136 mutual funds and various separately managed accounts, Federated provides comprehensive investment management worldwide to 5,500 institutions and intermediaries including corporations, government entities, insurance companies, foundations and endowments, banks and broker/dealers.

[2] The proposed amendments ("Proposals") were published for comment in Release No. IC-27255, February 28, 2006; 71 FR 11351, March 7, 2006 ("Release").

I. The Consequences of Non-Compliance with the Rule are Draconian and Should be Revised Significantly.

The Proposals attempt to deal with one aspect of the failure to comply with the Rule's requirements; namely, to prevent the lack of a shareholder information agreement (SIA) with one intermediary from affecting the redeemability of shares that investors own through other intermediaries. To do this, the SEC is proposing to revise the Rule to provide that, if a fund does not have the requisite SIA with one intermediary, the fund must thereafter prohibit that intermediary from purchasing fund shares on behalf of itself or other persons. According to the Release, the Commission "intend[s] this change to focus the remedy (prohibition of future purchases) on the particular intermediary that fails to execute an agreement with the fund."

In Federated's view, the issues surrounding failure to comply with the Rule are extremely serious and much broader than what is addressed in the Proposals. Moreover, the proposed approach for dealing with a fund's failure to obtain the requisite SIA with an intermediary is likely to impose significant hardship on innocent investors without serving as an effective incentive for the intermediary to enter into the requisite SIA with the fund. Our concerns in these areas and our suggested alternative approaches are discussed below.

A. The Rule Should NOT Make it Unlawful to Redeem Shares Under ANY Circumstances.

The problem described above (*i.e.*, the lack of an SIA with one intermediary affecting the redeemability of shares that investors own through other intermediaries) exists due to the Rule's opening sentence, which states that

> (a) … It is unlawful for any fund issuing redeemable securities, its principal underwriter, or any dealer in such securities, to redeem a redeemable security issued by the fund within seven calendar days after the security was purchased, unless it complies with the following requirements: [relating to *Board determination*; *Shareholder information*; and *Recordkeeping*].

Thus, *any* failure to comply with *any* of the Rule's requirements will apparently result in a fund being prohibited from redeeming shares within seven days of their issuance. In our view, the right to redeem a mutual fund share on any business day is not only a key defining characteristic of mutual funds,[3] it is also one of the key investor protections that Congress built into the ICA. Sacrificing the redeemability of mutual fund shares over a violation of any of the Rule's requirements is not a sound approach.

[3] *See* ICA §2(a)(32).

To illustrate the point, the Rule as written makes it unlawful for a fund to redeem shares within seven days of their issuance if, *for example*, it *misplaces* a copy of an SIA (and thereby fails to comply with the requirements of paragraph (a)(3) of the Rule to "maintain a copy" of each such agreement). This seems a bizarre and excessive result.[4]

Although we are hopeful that the Commission does not intend to force mutual funds to compromise the fundamental right of redemption for *any* reason, let alone a clerical filing error, we are puzzled as to why the Rule would be drafted in this manner to begin with. This is particularly so because sacrificing the redeemability of the fund's shares does not appear in any way to be necessary in order for the Rule to work.

We believe it would be a better approach (not to mention clearer drafting) simply to begin the Rule by stating:

> (a) … Any fund issuing redeemable securities shall comply with the following requirements: [relating to *Board determination*; *Shareholder information*; and *Recordkeeping*].

Accordingly, Federated urges the Commission to revise this aspect of the Rule so as to avoid any possible compromise of the redeemability of mutual fund shares.

B. Prohibition of Future Purchases is NOT an Effective Remedy.

As noted above, in order to prevent a fund's lack of an SIA with one intermediary from affecting the redeemability of shares that investors own through other intermediaries, the SEC is proposing to revise the Rule to provide that, if a fund does not have the requisite SIA with an intermediary, the fund must thereafter prohibit that intermediary from purchasing fund shares on behalf of itself or other persons.

As suggested above, this approach is misguided primarily because it addresses a symptom of what is wrong with the Rule, while ignoring the cause of the problem (which is the fact that the Rule purports to sacrifice redeemability of shares as the price of non-compliance with any of its provisions). However, even on its own terms, this proposed approach for dealing with a fund's failure to obtain the requisite SIA with an intermediary is inappropriate because it is likely to impose significant hardship on innocent investors without either serving as an effective incentive for the intermediary to enter into the requisite SIA with the fund, or imposing any meaningful penalty on an intermediary who refuses to do so.

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[4] Admittedly, this particular result could be avoided if the recordkeeping requirement relating to SIAs is made part of ICA Rules 31a-1 and 31a-2 (rather than continuing as a provision of Rule 22c-2). Nevertheless, serious issues relating to redeemability would remain under Rule 22c-2 (for example, where a fund board inadvertently fails to comply in a timely manner with some aspect of the Rule's "Board determination" requirements).

1. The proposed approach will harm innocent investors and mutual funds.
Under the proposed approach, if an intermediary does not enter into the requisite SIA with a fund, the fund must refuse all future purchase orders from that intermediary, *regardless of whether* honoring such orders would (in the words of the Rule) "violate policies established by the fund for the purpose of eliminating or reducing any dilution of the value of the outstanding securities issued by the fund" (*i.e.*, the fund's "trading policies"). Thus, *all* shareholders trading through that intermediary would be barred from making additional purchases of fund shares through that intermediary even if all such shareholders are *observing* the fund's trading policies. Shareholders wishing to add to their holdings would be forced to open new accounts through other intermediaries, a process that, at best, would be inconvenient. This would be particularly disruptive for shareholders who are participating in fund-sponsored programs for the systematic purchase of shares. As noted below, it is also likely that shareholders will simply find alternatives to additional investments in the affected funds. Thus, not only the shareholders, but also the funds themselves are likely to be harmed by the proposed approach.

2. The proposed approach will not be effective in encouraging intermediaries to enter into agreements with funds.
While the proposed approach is guaranteed to harm innocent investors, it is far from certain that it will have the desired effect of encouraging intermediaries to enter into SIAs with funds. The Release does not explain why the Commission believes the proposed approach would be effective in encouraging intermediaries to enter into SIAs, and we are also hard pressed to come up with a viable rationale.

One possibility is that the Commission may be relying on the intermediary's clients to bring sufficient pressure to bear to cause a recalcitrant intermediary to enter into SIAs with funds, presumably by threatening to take their accounts elsewhere. If so, we must point out that such a result is, at best, speculative. We believe it is at least as likely (if not more so) that a client would choose to keep its account with its chosen intermediary and find alternative investments (rather than find a new intermediary). Thus, the Commission can have no assurance that the proposed approach will have the desired effect. Indeed, shareholders who become prohibited from additional purchases into a fund would likely withdraw their remaining assets in that fund once a suitable alternative investment is found. If the Commission wishes to avoid these and additional "unintended consequence[s]" in connection with this Rule,[5] it needs to find an alternative approach.

3. There are viable alternatives.

(a) The Rule should focus the remedy on the intermediary, not on the shareholders and the fund.
If the Commission does not revise its approach along the lines suggested above in part I.A. of this letter, or discussed in (b) below, and decides to persist in going down the path reflected in the Proposals, it needs to find an alternative that would be effective in encouraging intermediaries to enter into SIAs with funds, while not harming innocent investors (and the

[5] *Cf.* discussion at section II.A. of the Release.

affected funds). The Rule should not attempt to restrict additional purchases by clients of intermediaries. Instead, Federated believes it would be preferable to look to direct economic incentives as a means to provide effective encouragement in this regard.

Specifically, where a financial intermediary holds fund shares for its customers in nominee name and trades those shares through an omnibus account with the fund, there will in all likelihood be an agreement between the intermediary and the fund (or the fund's underwriter) that governs such activity. Such agreements (*e.g.*, "dealer agreements," which are discussed further in (b) below) typically entitle the intermediary to receive various types of compensation in connection with such activity. The question is whether this agreement (or some related agreement) would meet the Rule's requirements for an SIA.

Thus, the Rule should be revised to prohibit a fund from making any payment pursuant to such an agreement unless the Rule's requirements for an SIA are met. To avoid circumvention, the Rule should also prohibit the fund's adviser, underwriter, and their affiliates from making payments out of their own resources to replace the revenue that the intermediary would have to forego under this approach.

As the Commission knows, intermediaries often receive, and rely on, payments from a fund and/or fund affiliates under a wide variety of arrangements. It has been Federated's experience that intermediaries who receive such payments are very reluctant to see them reduced, not to mention eliminated. Accordingly, we believe that the prospect of a mandated cessation of such payments would be highly effective in inducing intermediaries to enter into the requisite agreements. In contrast to the Commission's proposed approach (which would impose burdens on hapless innocent shareholders in the event of non-cooperation by their intermediary), our recommended approach would truly "focus the remedy" directly where it belongs - on the intermediary - while not penalizing innocent shareholders or the funds themselves.

(b). The Commission should act to regulate intermediaries directly. As we perceive it, the underlying regulatory objective, briefly stated, is to force intermediaries to respect the terms and conditions (including the trading policies) of the funds whose shares they sell and/or service. The various problems discussed in the Release only illustrate the difficulties in the SEC attempting to achieve this goal indirectly (through the mechanism of mandatory provisions in fund agreements) rather than in a straightforward manner by directly regulating the intermediaries whose conduct it wishes to control.

We understand that arguments in favor of direct regulation of intermediaries were made to the Commission at an earlier stage in this rulemaking proceeding, but that the Commission decided at the time to place the burden solely on the funds.[6] We urge the Commission to reconsider that decision.

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[6] *See* Release No. IC-26782, March 11, 2005; 70 FR 13328, March 18, 2005 (adopting Rule 22c-2; the "Adopting Release"); particularly discussion at footnote 44 and accompanying text.

All too often we have seen instances where the Commission and/or a self-regulatory organization (such as the National Association of Securities Dealers, Inc. – "NASD") has taken action against an intermediary who caused harm by failing to observe the terms and conditions established by mutual funds (and their underwriters). Indeed, such failures by intermediaries have been sufficiently varied and frequent that the NASD recently issued a "Member Alert" on this very subject.[7] The Member Alert notes that the mutual fund "dealer agreement" between the principal underwriter of a fund and a selling broker-dealer sets forth the terms and conditions under which the broker-dealer may participate in the sale and distribution of fund shares, and should adequately delineate the respective responsibilities of the parties in a manner reasonably designed to help ensure that the mutual fund sales and distribution process protects investors. Importantly, NASD notes that "a failure to adhere to obligations under the terms of a dealer agreement might be inconsistent with just and equitable principles of trade, and therefore a violation of NASD Conduct Rule 2110, particularly if the failure results in financial harm to investors."

In the Release, the Commission expresses its desire "to focus the remedy . . . on the particular intermediary that fails to execute an agreement with the fund." In our view, "remedies" could be much more effectively focused if the Commission imposed relevant requirements directly on the intermediaries. Doing so would virtually guarantee widespread compliance and, in the expectedly rare cases where an intermediary failed to comply, the Commission would have the option of imposing possibly severe "remedies" directly on the intermediary, without risking harmful side-effects on innocent shareholders and funds. Moreover, given the Rule's stated focus on redemption fees, direct SEC regulation of intermediaries in this area would also help assure that intermediaries faithfully apply a fund's redemption fee provisions and promptly remit such fees to the fund.

Even if the Commission is unwilling to exert its authority over intermediaries in this manner, it could greatly assist mutual funds in the arduous task securing the requisite SIAs by following the NASD's example and issuing its own statement regarding intermediaries' responsibilities in this area.

II. The Commission Should Provide a Transition Period of at Least Eighteen Months Following Adoption of the Proposals.

When the Commission adopted the Rule, it deferred the compliance date for approximately 18 months. As noted in section III of the Adopting Release, this was done "to give funds and their financial intermediaries ample time to make needed contractual amendments and system enhancements." Almost immediately after the Adopting Release was issued, the Commission began receiving comments, some of which pointed out the very shortcomings that the Proposals

[7] *NASD Reminds Members of Their Responsibilities Regarding Sales of Mutual Fund Shares and Dealer Agreements*, November 22, 2005.

are intended to address. It was not long before the Commission's staff began to give public indications that some type of adjustment to the Rule's provisions should be expected.

Against this backdrop, funds faced the dilemma of either proceeding with the arduous task of revising their agreements with intermediaries to meet the requirements of the Rule as adopted, or else postponing that task pending the possible revisions to the Rule, as noted in staff comments. Either way, now that the Proposals have been issued, funds are essentially "back to square one," because if the Proposals become final, even those funds that had begun to "re-paper" their agreements would have to revise them yet again to include additional new provisions.

Accordingly, for the very same reasons stated by the Commission in the Adopting Release, a transition period of at least as much time - 18 months - would also be warranted following adoption of the Proposals.

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Please contact me at 412-288-7496 with any questions about this submission.. Thank you.

Very truly yours,

Jay S. Neuman

Jay S. Neuman

cc: Peter Germain
Matthew Maloney