

FEDERATED MUNICIPAL FUNDS
Investment Company Act of 1940

November 20, 2006

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 200510111416

Federated Municipal Funds

File No. 132-3

Your letter dated November 15, 2006 requests that we extend the no-action position that we took in United Municipal Bond Fund (pub. avail. Jan. 27, 1995) (the "1995 letter") to address the use of Standard & Poor's Securities Evaluations, Inc. ("SPSE"), an independent pricing service, in connection with certain 17a-7 transactions, as defined below. In the 1995 letter, we agreed not to recommend enforcement action to the Securities and Exchange Commission (the "Commission") under section 17(a) of the Investment Company Act of 1940 (the "1940 Act") against certain affiliated funds if they use the prices provided by Muller Data Corporation, now operating as FT Interactive Data ("FTID"), an independent pricing service, when engaging in 17a-7 transactions involving certain municipal securities for which market quotations are not readily available.¹ We respond to your request below, and also provide general guidance concerning rule 17a-7 and best execution and the duty of loyalty, and the Nasdaq Official Closing Price.

Independent Pricing Services

Section 17(a) of the 1940 Act prohibits any affiliated person of a registered fund, or any affiliated person of such a person, from selling securities to, or purchasing securities from, the fund. Rule 17a-7 under the 1940 Act generally exempts from the prohibitions of section 17(a) certain purchases and sales of securities between funds that are affiliated solely by reason of having a common investment adviser ("17a-7 transactions"). As relevant here, rule 17a-7 requires that: the 17a-7 transactions involve securities for which market quotations are readily available; the 17a-7 transactions are effected at the independent current market prices of the securities; and the "current market price" for certain securities (such as municipal securities) is calculated by averaging the highest and lowest current independent bid and offer price determined on the basis of a reasonable inquiry.²

In the 1995 letter, we agreed not to recommend enforcement action to the Commission under section 17(a) of the 1940 Act against certain affiliated funds if they engaged in 17a-7 transactions involving municipal securities for which market quotations were not readily available. In the 1995 letter, the prices of the municipal securities that were to be used in the 17a-7 transactions were the same as the prices that were to be used to determine the funds' net asset values per share ("NAV") consistent with section 2(a)(41) of the 1940 Act and rule 2a-4 thereunder.³ Your letter specifically requests that we extend the no-action position in the 1995 letter to permit certain affiliated funds advised by Federated Investment Management Company (and other commonly controlled investment advisers) that invest primarily in municipal bonds (the "Municipal Funds") to use SPSE, rather than FTID, as their independent pricing service and engage in 17a-7 transactions under substantially similar circumstances.

In the 1995 letter, we did not intend that FTID would be the only independent pricing service that could be used by funds relying on the letter. It may be appropriate for a fund, subject to the approval of its board of directors, to use other independent pricing services for these purposes. Accordingly, we would not recommend enforcement action to the Commission under section 17(a) of the 1940 Act against the Municipal Funds if they use SPSE (or any other independent pricing service) as their independent pricing service and engage in 17a-7 transactions involving municipal securities for which market quotations are not readily available, provided that the Municipal Funds comply with all of the representations contained in the Municipal Bond Fund letters, other than their use of SPSE (or any other independent pricing service), rather than FTID, as their independent pricing service.⁴ Please note that this position represents our view on enforcement action only and does not express any legal conclusions on the issues presented. Furthermore, this position is based on all of the facts and representations in your letter; any different facts or representations may require a different conclusion.

Best Execution and the Duty of Loyalty

Before causing funds that it manages to enter into 17a-7 transactions, an investment adviser should carefully consider, among other things, its duty to seek best execution for each fund and its duty of loyalty to each fund. In particular, the investment adviser to the fund seeking to sell securities in a 17a-7 transaction should ensure that the selling fund's total proceeds are the most favorable under the circumstances.⁵ The investment adviser also should ensure that the buying fund's total cost is the most favorable under the circumstances.⁶ If the adviser to the selling fund can obtain greater proceeds for that fund by selling the security in the market, rather than by selling it to the other fund in a 17a-7 transaction, the adviser should sell the security in the market. The same principle applies to the buying fund's participation in a 17a-7 transaction.

In addition, consistent with an investment adviser's duty of loyalty, we believe that an investment adviser should not cause funds to enter into a 17a-7 transaction unless doing so would be in the best interests of each fund participating in the transaction. Thus, for instance, the buying fund should not participate in a 17a-7 transaction that benefits only the selling fund; if the buying fund were to participate in such a transaction, it may forgo an opportunity to make a better investment in a different security.

Nasdaq Official Closing Price

We also wish to take this opportunity to note that, in our view, the use of another pricing methodology, the Nasdaq Official Closing Price ("NOCP"), is consistent with the policies of section 17(a) and rule 17a-7. Rule 17a-7(b)(1) provides that the current market price for an "NMS stock," as that term is defined in 17 CFR 242.600, is:

[T]he last sale price with respect to such security reported in the consolidated transaction reporting system ('consolidated system') or the average of the highest current independent bid and lowest current independent offer for such security (reported pursuant to 17 CFR 242.602) if there are no reported transactions in the consolidated system that day.

The consolidated last sale price is comprised of the final last sale eligible trade report submitted to the Securities Information Processor during the regular trading session by any market center, including Nasdaq.

In April 2003, Nasdaq began calculating the NOCP, as an alternative to the consolidated last sale price, for a subset of NMS stock made up of all Nasdaq National Market securities (more than 3,900 companies that are the larger and generally more actively traded Nasdaq securities) and Nasdaq SmallCap securities (more than 1,300 securities of smaller, less-capitalized companies that do not qualify for inclusion in the Nasdaq National Market). The NOCP is based on the price of the last unmodified trade reported to Nasdaq's proprietary trade reporting system — Automated Confirmation Transaction System or "ACT" — at or before 4:00:02 pm. To determine the NOCP, Nasdaq systems then normalize that price by ensuring that it is at or within Nasdaq's best bid and ask quotations. The NOCP calculation does not affect, although it may differ from, the consolidated last sale price.⁷

We believe that funds' use of NOCP prices in 17a-7 transactions would be consistent with the policies underlying section 17(a) and rule 17a-7 because of the manner in which the NOCP prices are independently determined. We believe that NOCP prices provide "an independent basis for determining that the terms of the transaction are fair and reasonable to each participating investment company and do not involve overreaching."⁸ We would not recommend enforcement action to the Commission under section 17(a) of the 1940 Act against affiliated funds if, when engaging in 17a-7 transactions, the funds determine the current market price of a security that is NMS stock by using the NOCP price rather than by using one of the methodologies listed in rule 17a-7(b)(1).⁹ Of course, the funds must also comply with the other requirements of rule 17a-7. Please note that this position represents our view on enforcement action only and does not express any legal conclusions on the issues presented.

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Senior Counsel

Endnotes

1 The relief that we provided in the 1995 letter was based on the representations contained in that letter, as well as the representations contained in an earlier related letter, United Municipal Bond Fund (pub. avail. July 30, 1992) (the "1992 letter," together with the 1995 letter, the "Municipal Bond Fund letters").

2 See rule 17a-7(a); rule 17a-7(b); and rule 17a-7(b)(4).

3 In the 1992 letter, we provided similar no-action relief for 17a-7 transactions involving municipal securities for which market quotations were not readily available, the prices for which were to be obtained through pricing methodologies that differed from those that the funds used when calculating their NAVs. That approach, however, had the unintended effect of causing artificial gains and losses for the funds. As a result, in the 1995 letter, we altered our position in the 1992 letter.

4 For example, the 1995 letter included representations about the steps that the funds took to ensure the reliability of the prices supplied by the pricing service.

5 Although paragraph (d) of the rule generally provides that no brokerage commissions or fees may be charged in connection with 17a-7 transactions, an investment adviser nevertheless has a fiduciary duty to seek to execute any 17a-7 transaction in a manner that ensures that each fund's total cost or proceeds is the most favorable under the circumstances. See generally Securities Exchange Act Release No. 23170 (Apr. 23, 1986) (defining best execution of client trades).

6 See In the Matter of Michael L. Smirlock, Advisers Act Release No. 1393 (Nov. 29, 1993) (Advisory employee violated section 206(2) of the Investment Advisers Act of 1940 when he executed cross trades between advisory clients without, among other things, obtaining independent price information on the security involved from any dealer in order to obtain an accurate and independent evaluation of the market prices. "Thus, [he] did not take the necessary and proper steps to ensure that he obtained the best price and execution on behalf of his advisory clients who purchased the securities in the cross trades.")

7 See Securities Exchange Act Release No. 47517 (Mar. 18, 2003) (order granting approval to proposed rule change by the National Association of Securities Dealers, Inc. relating to the establishment of a NOCP); and Securities Exchange Act Release No. 47022 (Dec. 18, 2002) (notice of filing of proposed rule change by the National Association of Securities Dealers, Inc. relating to the establishment of a NOCP).

8 See Investment Company Act Release No. 11676 (Mar. 10, 1981) (adopting amendments to Rule 17a-7).

Rule 17a-7(b)(1) has been part of the rule since it was adopted originally in 1966. See Investment Company Act Release No. 4697 (Sept. 8, 1966). The Commission has amended rule 17a-7(b)(1) once since Nasdaq was permitted to establish a NOCP in 2003, but the Commission did not consider the use of NOCP prices in 17a-7 transactions in that amendment. See Securities Exchange Act Release No. 51808 (June 9, 2005) (adopting rules under Regulation NMS) ("the rules adopted today amend a number of rules [including rule 17a-7(b)(1)] that cross-reference current NMS rules or that use terms that Regulation NMS amends or eliminates. These amendments are intended to be non-substantive."). We believe that the Commission's non-inclusion of NOCP in rule 17a-7 does not signify its view that NOCP is inappropriate for purposes of the rule.

9 Most funds calculate their NAVs as of 4:00 p.m. Eastern time each business day. Such funds that engage in 17a-7 transactions using NOCP prices should use the prices in calculating their NAVs as well.

In general, Rule 17a-7 does not mandate a particular time at which 17a-7 transactions should take

place. See Investment Company Act Release No. 8494 (Sept. 13, 1974) (adopting amendments to Rule 17a-7), where the Commission stated:

Another comment suggested that an ambiguity may exist in the construction of the word 'last' in paragraph (b)... , i.e., whether 'last' refers to and means the sales price or bid and offer next preceding the transaction or whether 'last' means the closing sales or closing bid and offer on the day of the transaction. The word 'last' in paragraph (b) is intended to refer to sales prices which immediately precede the transaction being executed in accordance with the existing rule.

We note, however, that funds should use the NOCP price for 17a-7 transactions only when the NOCP price is the last sales price that immediately precedes the transaction. We also note that funds may agree, prior to the dissemination of an NOCP price, to engage in a 17a-7 transaction using that price. Thus, the 17a-7 transaction would take place as if it were simultaneous with the dissemination of the NOCP price.