

**MEMO# 10496**

November 18, 1998

## **SEC STAFF LETTER ON LEGAL ISSUES ARISING FROM PARTICIPATION IN ""FUND SUPERMARKETS""**

\* Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, Securities and Exchange Commission, dated October 30, 1998. [10496] November 18, 1998  
TO: DIRECTOR SERVICES COMMITTEE No. 9-98 RE: SEC STAFF LETTER ON LEGAL ISSUES  
ARISING FROM PARTICIPATION IN ""FUND SUPERMARKETS""

The staff of the SEC's Division of Investment Management has issued a letter to the Institute that outlines the Division's views on certain legal issues arising from mutual funds' participation in "fund supermarkets." In particular, the letter addresses payment of fund supermarket fees and emphasizes the important role of a fund's board of directors in determining the purpose of the payment (i.e., for distribution-related services vs. for administrative services). A copy of the letter is attached\* and it is summarized below. After briefly describing how fund supermarkets work, the letter discusses the results of examinations of fund supermarkets that the Office of Compliance Inspections and Examinations ("OCIE") recently conducted. According to the letter, OCIE found three variations on how fund supermarket fees are paid. Some funds treat all of the services they receive through supermarket programs as distribution-related and pay for them with 12b-1 fees. Other funds characterize part of the supermarket fee as administrative in nature pay a portion of the fee outside of a 12b-1 plan. In other cases, the fund's adviser or its affiliates pay a portion of the fee. The letter states that whether fund supermarket fees must be paid under a 12b-1 plan depends on (1) whether the payments are for services primarily intended to result in sales of fund shares and (2) who (i.e., the fund or another party) is making the payments. The letter indicates that if a fund participates in a fund supermarket program primarily to sell its shares, at least part of the fee must be treated as primarily intended to result in the sale of fund shares, and this part may be paid by the fund only under a 12b-1 plan. A fund that has a 12b-1 plan may pay for distribution expenses to the extent its plan permits. A fund that pays the entire fund supermarket fee under its 12b-1 plan need not determine what portion of the fee is primarily for distribution services and what portion of the fee is primarily for administrative services. The letter further states that a fund that does not have a 12b-1 plan cannot pay any portion of a fund supermarket fee that is primarily for distribution services out of fund assets. It may use its assets, however, to pay a fund supermarket sponsor for services the board has determined to be non- distribution services. If a fund's adviser pays the fund supermarket fee (or the portion of the fee determined to be primarily for distribution services) out of its own resources, Rule 12b-1 generally does not apply. It could apply in certain circumstances, however, such as where

there is an increase in the fund's advisory fee to compensate the adviser for paying the supermarket fee. The letter states that in future examinations, OCIE will closely scrutinize advisory fee increases that appear to be for this purpose. The letter describes the "critical role" of fund directors in determining whether any portion of a fund supermarket fee is for distribution. A fund's board must consider the nature of the services used by the fund or provided to the fund by the supermarket sponsor. One factor that the board should consider is the sponsor's characterization of the services that it offers. The letter states that a fund board could determine that the entire fund supermarket fee is for distribution services and should be paid under the fund's 12b-1 plan. Alternatively, the board could determine that only a portion of the fee is for distribution services. The letter advises that, in determining whether a particular payment is for distribution or non-distribution services, the board should review both the distribution and non-distribution services provided by the fund supermarket sponsor. Any portion of the fee that is paid by the fund for non-distribution services should be reasonable in relation to (a) the value of those services and the benefits received by the fund and its shareholders and (b) the payments the fund would have to make to another entity to perform the same services. If the board determined that none of the supermarket fee was for distribution services, the fund could pay the entire fee out of its assets if the board's determination was supported by all relevant factors. Such factors would include, among others: the nature of the services provided; whether the services provide any distribution benefits; whether the services provide non-distribution related benefits and are typically provided by fund service providers; the costs that the fund could reasonably be expected to incur for comparable services if provided by another party, relative to the total amount of the supermarket fee; and the characterization of the services by the fund supermarket sponsor. The letter indicates that OCIE will closely scrutinize the analysis by such a fund's board in future examinations. The letter further states that a fund board also should examine any supermarket fees that are paid by the fund's investment adviser to satisfy itself that there is no indirect use of fund assets for distribution. The letter notes that the board should periodically review its determinations to ensure that all payments are consistent with Rule 12b-1 and that the fund is not paying for any duplicate services. The letter states that OCIE will closely review the actions taken by boards of funds that participate in fund supermarkets. Marguerite Bateman Associate Counsel Attachment