

## **SEC ISSUES LETTER REGARDING MUTUAL FUND SUPERMARKET FEES**

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In an October 30, 1998 letter to the Investment Company Institute (the "Letter"), the Division of Investment Management of the Securities and Exchange Commission outlined its views on certain matters relating to mutual fund supermarket programs. The letter followed a recent review of mutual fund supermarket programs by the Commission's Office of Compliance Inspections and Examinations ("OCIE").

The Letter expresses the view that payment of fees for participating in mutual fund supermarkets may be made pursuant to or outside of Rule 12b-1 Distribution Plans, depending on the purpose for which the payment is made. The Division indicated that this determination of purpose must be made by a fund's board of directors and requires careful consideration and monitoring. The Letter is summarized below.

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### **INDUSTRY PRACTICES AS TO PAYMENT FOR PARTICIPATION IN FUND SUPERMARKETS**

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Mutual fund supermarket programs typically involve the provision of the following administrative services to participating mutual funds: sub-accounting; shareholder account set-up and maintenance; shareholder assistance; transaction processing and settlement; preparation and distribution of account statements and transaction confirmations; payment of fund distributions; and distribution of prospectuses. The Division noted that although participating funds receive similar types of services in supermarket programs, funds pay for those services in different ways. Certain funds treat all of these services as distribution-related, and pay for them through Rule 12b-1 Distribution Plans. Other funds treat all or a portion of these services as administrative in nature and pay for them outside of Rule 12b-1 Distribution Plans. In some cases, a fund's adviser or its affiliates pay for a portion of these services. According to the Letter, the fees paid to participate in mutual fund supermarket programs range from .25% to .40% annually of the average net asset value of the shares of the fund held through the program.

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**FUND SUPERMARKETS AND RULE 12b-1**

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Rule 12b-1 requires that any payments by a fund in connection with the distribution of its shares be made pursuant to a written plan authorized by the fund's shareholders and board of directors (including a majority of the independent directors). The fund must also disclose in its prospectus detailed information describing the material aspects of its 12b-1 plan and any fees it pays pursuant to it. In conducting its review of supermarket programs, the OCIE sought to determine whether "funds that treated some or all of the fund supermarket fee as payment for non-distribution services were financing the distribution of their shares outside of a Rule 12b-1 plan," in violation of Rule 12b-1.

In the Letter, the Division indicated that the requirement that a fund supermarket fee be paid pursuant to Rule 12b-1 depends on (a) whether the payments are being made for services that are primarily intended to result in the sale of the fund's shares, and (b) whether the fund or another party is making some or all of the payments. The Division noted that if the fee relates to distribution services, then the fund may pay the fee out of fund assets only pursuant to a Rule 12b-1 plan. To the extent that a portion of the supermarket fee relates to non-distribution services, that portion may be paid out of fund assets without violating Rule 12b-1 and irrespective of whether the fund has adopted a 12b-1 plan. The Division noted that to simplify things, a fund could pay all of its supermarket fees pursuant to a Rule 12b-1 plan, eliminating the need to determine which portion of the fee relates to distribution of shares and which relates to administrative or other services.

In its review of several funds, the OCIE found that the funds examined had concluded that at least some of the services they had received from fund supermarket sponsors were distribution services that could be paid by the funds only pursuant to Rule 12b-1 plans. The OCIE noted that none of the funds examined was currently paying its entire supermarket fee from fund assets outside of a Rule 12b-1 plan. The OCIE also found that the boards of directors of many participating funds had determined that a portion of the fund supermarket fee is a non-distribution expense, noting that because supermarket sponsors provide services that would otherwise be provided by the funds' service providers and paid for by the funds, the funds are able to reduce the payments they would otherwise make to their service providers.

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**PAYMENT OF SUPERMARKET FEES BY  
INVESTMENT ADVISERS**

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The Division noted that Rule 12b-1 would generally not apply if a fund's investment adviser makes distribution-related payments out of its own resources, including payments for the portion of a fund supermarket fee that is for services primarily intended to result in the sale of fund shares. The Division indicated, however, that an indirect use of fund assets for distribution would result if any allowance were made in the investment adviser's fee to provide money to finance distribution. In future examinations, the OCIE intends to closely scrutinize

any increase in a fund's investment advisory fee that appears to be for the purpose of compensating the adviser for paying supermarket fees.

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**ROLE OF A FUND'S BOARD OF  
DIRECTORS**

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The Division indicated that the board of directors of a fund that participates in supermarket programs plays a critical role. The Division noted that the board is responsible for determining whether any portion of a fund supermarket fee paid by the fund is for distribution. This determination involves considering the nature of the services used by the fund or provided by the supermarket sponsor. The Division noted that the sponsor's characterization of the services offered is one factor the board should consider in making this determination.

If a board determines that a portion of a fund supermarket fee is for distribution services and a portion is not, the Division advised that the board should review the nature of the services and determine whether the portion of the fee paid by the fund for non-distribution services is reasonable in relation to (a) the value of those services and the benefits received by the fund and its shareholders and (b) the payments that the fund would be required to make to another entity to perform the same services. As an example, the Division noted that if a fund pays a 25 basis points supermarket fee and the board determined that the value of the non-distribution services was 20 basis points, the board could conclude that the 20 basis points portion of the fee need not be paid by the fund under a Rule 12b-1 plan.

If a board determines that none of a supermarket fee is for distribution services, and the fund pays the entire fee out of its own assets, the Division indicated that the board would need to satisfy itself that the determination was supported by all relevant factors. The relevant factors identified by the Division include 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 OCIE staff intends to closely scrutinize this analysis by a fund's board in future examinations.

The Division indicated that where a fund's adviser pays supermarket fees, the board must satisfy itself either that the management fee is not a conduit for the indirect use of fund assets for distribution, or that the fund has complied with Rule 12b-1. The Division noted that there is no indirect use of fund assets for distribution if the adviser makes distribution-related payments out of its own resources.

Finally, the Division indicated that a fund's board should periodically review its determinations to ensure compliance with Rule 12b-1, and to ensure that the fund is not paying the supermarket sponsor for services that duplicate services already being provided to the fund.

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If you have any questions concerning this development, please do not hesitate to contact Gary S. Schpero (212-455-3665), Sarah E. Cogan (212-455-3575), or Robert Kaner (212-455-3275).

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