

transfer agents²⁷ (collectively, “service providers”) through which the fund conducts its activities.²⁸

a. *Service Providers.* Most of the operations of funds are carried out by service providers, which have their own compliance policies and procedures. Commenters pointed out that the proposed rule appeared to require a fund to adopt, as its own, the policies and procedures of its service providers.²⁹ The final rule requires fund boards to approve the policies and procedures of fund service providers, and requires the fund’s policies and procedures to include provisions for the fund to oversee compliance by its service providers.

Rule 38a–1 provides fund complexes with flexibility so that each complex may apply the rule in a manner best suited to its organization.³⁰ A fund complex could, for example, adopt compliance policies and procedures that encompass the activities of the funds, the adviser and affiliated underwriters and transfer agents, while approving the policies and procedures of other service providers, such as subadvisers, over which it has oversight responsibility under the rule. Another fund complex could adopt policies and procedures that would cover solely activities of the funds, and could approve the policies and procedures of each of its service providers.

b. *Board Approval.* Rule 38a–1 requires a fund’s board, including a majority of its independent directors, to approve the policies and procedures of the fund and each of its service

providers.³¹ The approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal securities laws by the fund and its service providers.³²

Some commenters expressed concern that the rule would require directors to review lengthy compliance manuals and devote considerable time at each meeting to approving numerous amendments. Directors may satisfy their obligations under the rule by reviewing summaries of compliance programs prepared by the chief compliance officer, legal counsel or other persons familiar with the compliance programs. The summaries should familiarize directors with the salient features of the programs (including programs of service providers) and provide them with a good understanding of how the compliance programs address particularly significant compliance risks.³³

In considering whether to approve a fund’s or service provider’s compliance policies and procedures, boards should consider the nature of the fund’s exposure to compliance failures. In the case of a money market fund, for example, the board should consider whether the policies and procedures sufficiently address the fund’s compliance with rule 2a–7.³⁴ Boards should also consider the adequacy of the policies and procedures in light of their recent compliance experiences, which may demonstrate weaknesses in the fund or service provider’s compliance programs. We urge boards

to also consider best practices used by other fund complexes, and to consult with fund counsel (and independent directors with their counsel), compliance specialists and other experts familiar with compliance practices successfully employed by similar funds or service providers.

The Commission understands that, in some cases, the fund may employ the services of a service provider that is not an affiliated person of the fund, such as a transfer agent or administrator, and that provides similar services to a large number of funds. In such cases, it may be impractical for the fund or its compliance officer to directly review all of the service provider’s policies and procedures. In such cases, we will consider a fund’s policies and procedures to have satisfied the requirements of this rule if the fund uses a third-party report on the service provider’s procedures instead of the procedures themselves when the board is evaluating whether to approve the service provider’s compliance program.³⁵ The third-party report must describe the service provider’s compliance program as it relates to the types of services provided to the fund, discuss the types of compliance risks material to the fund, and assess the adequacy of the service provider’s compliance controls.³⁶

c. *Policies and Procedures.* Funds’ or their advisers’ policies and procedures should address the issues we identified for investment advisers above.³⁷ In

²⁷ Section 3(a)(25) of the Securities Exchange Act of 1934 (15 U.S.C. 78c–3(a)(25)) defines a “transfer agent” as “any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in (A) countersigning such securities upon issuance; (B) monitoring the issuance of such securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar; (C) registering the transfer of such securities; (D) exchanging or converting such securities; or (E) transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates.”

²⁸ In this release, we use the term “service provider” to refer only to a fund’s advisers, principal underwriters, administrators, and transfer agents. By limiting the term in this manner, we are not lessening a fund’s obligation to consider compliance as part of its decision to employ other entities, such as pricing services, auditors, and custodians.

²⁹ Some commenters urged us to permit funds to simply rely on their service providers’ policies and procedures. We have not adopted this suggestion because it would permit funds and their boards to absolve themselves of responsibility for compliance activities of the service providers through which funds conduct most of their activities.

³⁰ In this release, we use the term “fund complex” to mean a group of funds that share a compliance program and a common investment adviser and/or distributor.

³¹ In this release, we refer to directors who are not “interested persons” of the fund as “independent directors.” Section 2(a)(19) identifies persons who are “interested persons” of a fund. 15 U.S.C. 80a–2(a)(19).

³² Rule 38a–1(a)(2). In response to comments seeking clarification of the board’s responsibilities, we have added language to the rule text explicitly stating the basis for approval. If the policies and procedures of a service provider are included within the policies and procedures adopted by the fund, separate approval by the board is not required. A fund that is approving policies and procedures of service providers is required to make findings only with respect to activities of the service provider that could affect the fund.

³³ Rule 38a–1 does not require fund boards to approve amendments to policies and procedures of the fund or its service providers. Such a requirement would, as commenters pointed out, inundate fund boards with review of minor changes and detract from their ability to address significant responsibilities committed to them by the Act and our rules. Moreover, such a requirement could delay funds and their service providers from making needed changes. Instead, the rule requires the fund’s chief compliance officer to discuss material changes to the compliance policies and procedures in his or her annual report to the fund board. Rule 38(a)–1(a)(4)(iii)(A). As we note below, however, serious compliance issues must be raised with the board immediately. See *infra* note 83.

³⁴ 17 CFR 270.2a–7.

³⁵ In these limited circumstances, we would also consider the fund to have satisfied the rule’s requirement with regard to annual review of service providers, as discussed in section II.B.2. of this release, *supra*, and with respect to the chief compliance officer’s annual report with regard to service providers, as discussed in section II.C.2. of this release, *supra*, if such reviews and reports use such third-party reports provided to the fund no less than annually. If the fund uses such reports for its approval of a service provider’s compliance program or the annual review or reporting on the program, the fund must also gather and take into account other relevant information, such as its experience with the service provider.

³⁶ See, e.g., Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 70, Reports on Processing of Transactions by Service Organizations (American Inst. of Certified Public Accountants).

³⁷ See *supra* text accompanying notes 17 through 22. Funds are also subject to requirements to maintain written compliance policies and procedures in certain of our rules. The new rules do not supplant these requirements. See, e.g., Investment Company Act rules 2a–7(c)(7) (17 CFR 270.2a–7(c)(7)) (requiring boards of money market funds to establish written procedures “reasonably designed * * * to stabilize the money market fund’s net asset value per share”) and 17j–1(c)(1) (17 CFR 270.17j–1(c)(1)) (requiring funds to “adopt a written code of ethics containing provisions reasonably necessary to prevent” certain persons affiliated with the fund, its investment adviser or