GODFREY & KAHN S.C.
ATTORNEYS AT LAW

780 NORTH WATER STREET
MILWAUKEE, WI 53202-3590
TEL 414-273-3500
FAX 414-273-5198
www.gklaw.com

GODFREY & KAHN, S.C.
MILWAUKEE
APPLETON
GREEN BAY
WAUKESHA

LAFOLLETTE GODFREY & KAHN
MADISON

MEMORANDUM

TO: Our Clients and Friends

FROM: Godfrey & Kahn, S.C.

DATE: December 10, 2002

RE: Recent SEC Rule Proposals and Proposed Amendments Applicable to Registered Investment Companies

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In response to the Sarbanes-Oxley Act of 2002 (the "Sarbanes Act"), and as part of its ongoing initiative to improve the quality of disclosures by mutual funds, the Securities and Exchange Commission (the "SEC") recently published a release (the "Release") proposing new rules and amendments to current rules relating to:

- *disclosure regarding financial experts serving on an investment company's audit committee, in response to Section 407 of the Sarbanes Act;*
- *disclosure regarding the adoption (or non-adoption) of a code of ethics for senior financial officers (as well as the principal executive officer) by an investment company, its investment adviser and its principal underwriter, in response to Section 406 of the Sarbanes Act; and*
- *evaluation and disclosure regarding an investment company's disclosure controls and procedures and internal controls and procedures for financial reporting.*

This memorandum is intended to provide a summary of the rules and amendments proposed by the SEC in the Release. The proposals are subject to a 30-day comment period, after which the SEC will issue final rules. We expect the final rules and amendments to be substantially similar to the proposed rules and amendments.

I. Proposed Disclosure About Financial Experts Serving on an Investment Company's Audit Committee

In response to Section 407 of the Sarbanes Act, the SEC has proposed to add a new disclosure item to proposed Form N-CSR which would require registered management investment companies to disclose annually:

- the number and names of persons that the board of directors has determined to be the "financial experts" serving on the investment company's audit committee; and

- whether the financial expert or experts are "independent," and if not, an explanation as to why they are not.

If an investment company has no financial expert serving on its audit committee, the proposed rule would require the investment company to disclose that fact and explain why it has no financial expert.

Under the proposed rules, the term "financial expert" would be defined to mean a person who possesses all of the following attributes:

- an understanding of generally accepted accounting principles ("GAAP") and financial statements;

- experience applying GAAP in connection with the accounting for estimates, accruals, and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the company's financial statements;

- experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the company's financial statements;

- experience with internal controls and procedures for financial reporting; and

- an understanding of audit committee functions.

The person may have obtained these attributes through any of several means, including through (i) education and experience as a public accountant/auditor or a chief financial officer, controller, or principal accounting officer of a company which, at the time a person held such position, was a public company (including an investment company), or (ii) experience in one or more positions that involve the performance of similar functions (or that results, in the judgment of the company's board of directors, in the person having similar expertise and experience). If the board of directors determines that a person is a financial expert because, in the board's judgment, he or she has attributes similar to those listed in the proposal, the investment company must disclose that determination.

An instruction to the proposed rule would set forth a number of factors that the board of directors should consider in evaluating an individual's education and experience. These factors include:

- the level of the person's accounting or financial education, including whether the person has earned an advanced degree in finance or accounting;

- whether the person is a certified public accountant, or the equivalent, in good standing, and the length of time that the person actively has practiced as a certified public accountant, or the equivalent;

- whether the person is certified or otherwise identified as having accounting or financial experience by a recognized private body that establishes and administers standards in respect of such expertise, whether that person is in good standing with the recognized private body, and the length of time that the person has been actively certified or identified as having this expertise;

- whether the person has served as a principal financial officer, controller or principal accounting officer of a company that, at the time the person held such position, was a public company (including an investment company), and if so, for how long;

- the person's specific duties while serving as a public accountant, auditor, chief financial officer, controller, principal accounting officer or position involving the performance of similar functions;

- the person's level of familiarity and experience with all applicable laws and regulations regarding the preparation of financial statements that must be included in periodic reports filed with the SEC;

- the level and amount of the person's direct experience reviewing, preparing, auditing or analyzing financial statements that must be included in periodic reports filed with the SEC;

- the person's past or current membership on one or more audit committees of companies that, at the time the person held such membership, were public companies (including investment companies);

- the person's level of familiarity and experience with the use and analysis of financial statements of public companies (including investment companies); and

- whether the person has any other relevant qualifications or experience that would assist him or her in understanding and evaluating the company's financial statements and other financial information and to make knowledgeable and thorough inquiries whether (i) the financial statements fairly present the financial condition, results of operations and cash flows of the company in accordance with GAAP, and (ii) the financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

This list of factors is not meant to be exhaustive, and the proposed rules do not specify the number of listed factors that a financial expert should satisfy. According to the Release, the fact that a person has previously served on an audit committee would not, by itself, justify the board of directors in "grandfathering" that person as a financial expert under the proposed definition.

Similarly, the fact that a person has experience as a public accountant or auditor, or as a chief financial officer, controller or principal accounting officer, or experience in a similar position, would not, by itself, justify the board of directors in deeming that person to be a financial expert.

Based on the foregoing, even financially literate, sophisticated and experienced business persons may not necessarily qualify as "financial experts." If the board of directors cannot make the determination that the persons serving on the investment company's audit committee are so qualified, disclosure that the audit committee does not contain any financial experts will be required.

In order to be considered "independent" under the proposed rules, an audit committee member may not—other than in his or her capacity as a member of the audit committee, the board of directors or any other board committee—accept any consulting, advisory or other compensatory fee from the company, or be an "interested person" of the investment company as that term is defined in the Investment Company Act of 1940 (the "Investment Company Act").

II. Proposed Code of Ethics Disclosure

The Release also contains a proposal to amend Form N-SAR and proposed Form N-CSR to require a registered investment company to disclose annually whether the investment company, its investment adviser and its principal underwriter have adopted a written code of ethics applicable to the principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions of, respectively, the investment company, its investment adviser and its principal underwriter. If no such code of ethics has been adopted, the investment company would be required to explain the reasons why.

If the investment company, its investment adviser or its principal underwriter has, during the period covered by the report, amended or granted a waiver from any provision of the code of ethics described above, the investment company would be required to provide a brief description of the amendment or waiver in its report on Form N-SAR or proposed Form N-CSR, as applicable. In the alternative, the investment company would have the option of disclosing this information on its Internet website within two business days after the occurrence of the amendment or waiver, if the investment company:

- has disclosed in its most recently filed report on Form N-SAR or N-CSR its intention to provide disclosure in this manner;
- has disclosed in its most recently filed report on Form N-SAR or N-CSR its Internet address;
- makes the information available on its website for a twelve-month period; and
- retains the information for a period of not less than six years following the end of the fiscal year in which the amendment or waiver occurred.

An investment company would be required to include any written code of ethics and amendment to that code of ethics as an exhibit to the investment company's reports on Form N-SAR or proposed Form N-CSR.

The proposed rule would define "code of ethics" as a codification of standards that is reasonably designed to deter wrongdoing and to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interests between personal and professional relationships;

- avoidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict;

- full, fair, accurate, timely and understandable disclosure in reports and documents that an investment company files with, or submits to, the SEC and in any other public communications made by the investment company;

- compliance with applicable governmental laws, rules and regulations;

- the prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and

- accountability for adherence to the code.

The proposed rules do not specify every detail that an investment company must address in its code of ethics, nor do they specify the procedures that an investment company should develop or the types of sanctions that an investment company should impose to ensure compliance with its code of ethics. According to the Release, a pre-existing code of ethics may satisfy the requirements of the proposed rule, but an investment company should review its code after the final rules are adopted to determine whether the code meets all of the standards included in the definition of a "code of ethics." If a pre-existing code of ethics does not satisfy all parts of that definition, the investment company would not be able to affirm that it has the type of code contemplated by the rules.

Pursuant to Rule 17j-1 under the Investment Company Act, investment companies are currently required to adopt codes of ethics designed to prevent fraud resulting from personal trading in securities by portfolio managers and other employees. According to the Release, the proposed rules would address a broader range of conduct, including disclosure provided in filings with the SEC, compliance with governmental laws, rules and regulations, and ethical conduct generally. To the extent that an investment company, or its investment adviser or principal underwriter, is considering implementing new or changed code of ethics provisions as a result of the proposed rules, it may wish to incorporate the proposed provisions, together with its existing code of ethics under Rule 17j-1, into a single, comprehensive code of ethics.

III. Proposed Amendments related to Disclosure Controls and Procedures and Internal Controls and Procedures for Financial Reporting

In order to conform with rule changes proposed for public operating companies, the SEC has proposed changes to the rules and forms implementing the certification requirements of Section 302 of the Sarbanes Act for registered investment companies. Section 302 of the Sarbanes Act requires an investment company's principal executive and financial officers to

certify to, among other things, the investment company's "disclosure controls and procedures." The term "disclosure controls and procedures" refers to controls and other procedures that are designed to ensure that information required to be disclosed in prospectuses, shareholder reports and other filings, both financial and non-financial, is recorded, processed, summarized and reported within the required deadlines.

The proposed amendments would specify that, as part of the Section 302 certifications, an investment company's management must evaluate the effectiveness of its disclosure controls and procedures, with the participation of the principal executive and financial officers, as of the end of the period covered by each report filed on Form N-SAR or proposed Form N-CSR (as opposed to within 90 days prior to the filing date of the applicable report, as previously required).

In addition, the proposed amendments would introduce a new requirement to the Section 302 certification process. Namely, officers signing Form N-SAR or proposed Form N-CSR would be required to state that they are responsible for establishing and maintaining "internal controls and procedures for financial reporting," and that they have disclosed to the investment company's auditors and audit committee all significant deficiencies in the design and operation of such internal controls and procedures for financial reporting that could adversely affect the investment company's ability to record, process, summarize and report financial information required to be disclosed in its SEC reports. Any significant changes to an investment company's internal controls and procedures for financial reporting made during the period covered by the report would also need to be disclosed.

According to the Release, the purpose of "internal controls and procedures for financial reporting" is to ensure that investment companies have processes designed to provide reasonable assurance that the investment company's transactions are properly authorized, that its assets are safeguarded against unauthorized or improper use and that its transactions are properly recorded and reported to permit the preparation of its financial statements in conformity with GAAP. To meet these objectives, the SEC proposes to define the term "internal controls and procedures for financial reporting" as controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP.

We will continue to monitor the SEC proposals and keep you apprised of any new developments. In the meantime, please do not hesitate to contact us.

Godfrey & Kahn Investment Management Practice Group

Kenneth C. Hunt, khunt@gklaw.com
Carol A. Gehl, cgehl@gklaw.com
Pamela M. Krill, pkrill@gklaw.com
Ellen R. Drought, edrought@gklaw.com
Michelle M. Nelson, mnelson@gklaw.com
Jake C. Blavat, jblavat@gklaw.com
C.J. Wauters, cwauters@gklaw.com
Susan M. Hoaglund, shoaglun@gklaw.com