



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: August 16, 2004

RE: New Corporate Governance Rules Affecting Mutual Funds

In July 2004, the SEC adopted several controversial rules and rule amendments that will change the face, and function, of mutual fund boards. These rules were adopted in response to a series of abuses committed by mutual funds that rely upon certain exemptive rules which enable those funds to conduct transactions involving conflicts of interest that would otherwise be impermissible under the Investment Company Act. The rules are intended to increase the independence of fund boards and minimize the ability of fund advisers to dominate the fund board.

The rules become effective September 7, 2004, and compliance is required by January 16, 2006.

I. Overview of New Rules

The SEC has modified ten exemptive rules under the Investment Company Act to mandate that any fund relying on any of the exemptive rules¹ (Exemptive Rules) must meet the fund governance standards delineated in new Rule 0-1(a)(7), as follows:

- at least 75% of the directors of the fund must be independent directors or, if the fund board has only three directors, all but one of the directors must be independent directors;

¹ The exemptive rules are Rules 10f-3, 12b-1, 15a-4(b)(2), 17a-7, 17a-8, 17d-1(d)(7), 17e-1, 17g-1(j), 18f-3, and 23c-3.

- the chairman of the board must be an independent director;
- the board must perform a self-assessment at least once annually;
- the independent directors must meet separately at least once a quarter; and
- the independent directors must be affirmatively authorized to hire their own staff.

In addition, the SEC has amended Rule 31a-2 to require that a fund keep copies of the written materials considered by the board during the process of establishing a contract with the fund adviser.

II. Changes to Exemptive Rules

A. Board Composition

As noted above, the final rules stipulate that a fund relying on any of the Exemptive Rules must have a board containing a minimum of 75% independent directors. In the event only three directors are on a fund's board, at least two out of the three directors must be independent.

Prior to these amendments, the Exemptive Rules required that only a simple majority of the board be composed of independent directors. According to the SEC, under the previous requirements, the management directors could exploit their superior knowledge of the fund to manipulate the setting of the board's agenda and dominate board deliberations. By heightening the board composition requirements, the SEC seeks to resolve this imbalance by placing the board more firmly under the control of the independent directors whose role it is to represent the interests of fund investors.

B. Independent Chairman of the Board

A fund relying on any of the Exemptive Rules must also have a board chaired by an independent director. By having an independent chairman, the SEC believes that a fund can better avoid the conflicts of interest that tend to impair the ability of the fund board to carry out its role of protecting the interests of the fund and its shareholders. According to the SEC, when a board chairman does not have a divided loyalty between the fund and the fund's investment adviser, the board chairman can better represent the fund shareholders when conducting his or her duties.

C. Annual Self-Assessment

The directors of a fund relying on any of the Exemptive Rules must also conduct an annual assessment of the operation of the fund board and the board's committees. The assessment must involve an analysis of the effectiveness of the committee structure of the fund board and the number of funds on whose boards each director serves. While the amendment

does not mandate that this annual self-assessment must be in writing, the SEC expects that the board minutes will indicate the nature of the topics discussed during the self-assessment.

D. Separate Executive Sessions

The independent directors of a fund relying on any of the Exemptive Rules must also conduct a separate meeting, free from the presence of any directors who are interested persons of the fund, at least once every quarter. While the rules do not delineate specific matters for discussion at the independent directors' quarterly meeting, the SEC anticipates that the independent directors will discuss their opinions of the performance of the fund's investment adviser and other service providers.

E. Independent Director Staff

Finally, a fund relying on any of the Exemptive Rules must explicitly authorize its independent directors to hire employees and to retain advisers and experts necessary to carry out their duties. This amendment aims to provide the necessary aid to independent directors who need assistance in addressing complex matters. In addition to enabling independent directors to deal with complicated issues, the SEC also believes the amendment will furnish them with an understanding of other mutual funds' practices.

III. Recordkeeping for Approval of Advisory Contracts

Apart from the amendments to the Exemptive Rules discussed above, the SEC also amended Rule 31a-2, the fund recordkeeping rule. Pursuant to the amendment, funds must keep copies of the written materials evaluated by directors while approving a contract with a fund's investment adviser for a period of six years, keeping the materials in an easily accessible place during the first two years. The purpose of this amendment is to improve the documentation of a fund board's basis for approving an advisory contract, which will assist the SEC's examination staff in determining whether fund directors are fulfilling their fiduciary duties when approving advisory contracts. The SEC also believes that the amendment may cause independent directors to make larger information requests from the adviser during contract negotiations, which may enable the fund to acquire a more favorable advisory contract.

* * *

We will continue to monitor the SEC's activities for new developments. In the meantime, please do not hesitate to contact us if you have any questions.

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
Christopher M. Cahlamer, ccahlamer@gklaw.com
Susan M. Hoaglund, shoaglund@gklaw.com
Jasna B. Dolgov, jdolgov@gklaw.com

MN215544_1.DOC