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**In This Issue:**

- [SEC I: Reports Say Commissioners "Deeply Divided" Over Proxy Reform](#)
- [SEC II: SEC Will Make Corp Fin and Investment Management Comment Letters and Filer Responses Available on its Web Site](#)
- [SEC III: SEC Issues Final Rule on Exchange Act Section 31 Collection Practices](#)
- [SEC IV: SEC Issues Final Disclosure Rule Regarding Approval of Investment Advisory Contracts](#)
- [SEC V: SEC Adopts Changes to Short Sale Rules](#)
- [SEC VI: SEC Adopts Rule Amendments To Improve Governance of Investment Companies and Independence of Fund Directors](#)
- [SRO I: Reminder to NASD Members That Deadline for Adopting Business Continuity Plans Is Fast Approaching](#)
- [PCAOB I: PCAOB's Internal Controls Standards Approved by SEC](#)
- [PCAOB II: PCAOB Adopts Auditing Standard No. 3: Audit Documentation](#)
- [PCAOB III: PCAOB Adopts Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms](#)
- [DELAWARE CHANCERY COURT: Court Issues Decision Addressing Undisclosed Merger Negotiations](#)
- [PRACTICAL GUIDANCE: Courtesy of RealCorporateLawyer.com](#)
- [COMINGS AND GOINGS: Who's Doing and Saying What and Where?](#)

**SEC I: Reports Say Commissioners "Deeply Divided" Over Proxy Reform**

Labaton, Stephen, [S.E.C. at Odds on Plan to Let Big Investors Pick Directors](#), N.Y. Times Online (Jul. 1, 2004).

Reports suggest that the Commission's efforts to finalize a proposal to open proxy contests to candidates proposed by large shareholders are in trouble. For example, according to *The New York Times*, in an interview with a representative of the paper conducted on June 30, SEC Chairman William H. Donaldson "said he had been unable to forge an agreement among his deeply divided colleagues over" such a proposal. According to the same report:

"The deadlock all but dooms prospects for the rule to be adopted in time for the new proxy season that begins early next year. . . . The paralysis at the agency is a major victory for corporate executives who have fought to kill the rule and a setback for labor organizations and institutional investors who have pushed for years to get the commission to adopt it."

Early versions of the Commission's proposal have been widely criticized. Indeed, the Business Roundtable is not the only industry organization to oppose it. The U.S. Chamber of Commerce has also been vigorous in its opposition to the proposal.

The scorecard is as follows. Commissioners Harvey Goldschmid and Roel Campos apparently support the proposal. Commissioners Paul Atkins and Cynthia Glassman have questioned the proposal. Although Chairman Donaldson expressed initial support for the proposal, recently he seems to have been the driving force behind an effort to develop a compromise proposal that might bridge the gap between the two camps. *According to The New York Times*, when asked directly regarding the matter, Chairman Donaldson said "[r]ight now there is no consensus . . . I'm not sure I agree with what anyone else thinks or anyone agrees with what I think."

## **SEC II: SEC Will Make Corp Fin and Investment Management Comment Letters and Filer Responses Available on its Web Site**

U.S. Securities and Exchange Commission, [SEC Staff to Publicly Release Comment Letters and Responses](#), News Release 2004-89 (June 24, 2004).

On June 24, the SEC issued a news release stating that it plans to make Division of Corporation Finance and Division of Investment Management comment letters and filer responses available on its Web site. The announcement applies only to

comment letters and response letters relating to disclosure filings made after August 1, 2004, although no such material will be posted until at least "45 days after the staff has completed a filing review."

Some reportedly have been surprised to learn that CORRESP and COVER documents are not automatically treated as confidential. While the Commission previously considered such documents to be non-public, they were never considered confidential. Until now, the SEC released such staff comment letters and responses to such comment letters only in response to FOIA requests after the staff review was completed. In the last year, online services began filing FOIA requests for such materials and began making them available to paid subscribers via their systems. Apparently in response to such developments, the Commission announced its plans to make such materials more easily available to the public.

SEC Rule 83 (17 CFR 200.83) allows filers to request confidential treatment for some portions of a written response to a staff comment letter. According to the Commission:

"That rule requires the filer to submit its response letter using two separate documents -- a response to the comment letter without the confidential information, which we refer to as the redacted version, and a separate paper document including the confidential information. This separate document must be properly marked as confidential in accordance with Rule 83."

Significantly, in its news release the Commission makes clearly that currently it intends "to release only the redacted version of response letters where there is a Rule 83 request for confidential treatment." The Commission further emphasized that since it plans to make all comment letters and responses publicly available, either in response to FOIA requests or by publicly posting them in accordance with its news release, it will begin asking all companies for a so-called "Tandy Letter" providing representations that the company "will not use the SEC's

comment process as a defense in any securities related litigation against them."

### **SEC III: SEC Issues Final Rule on Exchange Act Section 31 Collection Practices**

U.S. Securities and Exchange Commission, [Collection Practices Under Section 31 of the Exchange Act](#), Release No. 34-49928 (June 28, 2004).

The SEC issued a final rule on collection practices under Section 31 of the Exchange Act on June 28. The rule is intended to establish "new procedures to govern the calculation, payment, and collection of fees and assessments on securities transactions owed by national securities exchanges and national securities associations to the Commission" under Section 31. Under that section, a national securities exchange must pay the Commission a fee based on the aggregate dollar amount of sales of securities transacted on the exchange. Under Section 31(b), a national securities exchange must pay the Commission a fee based on the aggregate dollar amount of sales of securities transacted on the exchange. Pursuant to Section 31(c), a national securities association must pay the Commission a fee based on the aggregate dollar amount of sales of securities transacted by or through any member of the association otherwise than on a national securities exchange. Section 31(d) requires a national securities exchange to pay the Commission an assessment for each "round turn transaction" in a security future.

In the past, the Commission has not defined the phrase "sales of securities" as used in Section 31. Nor has it mandated any formal procedure for aggregating trading volumes for purposes of calculating Section 31 fees. Rather, the Commission relied on SROs to develop their own procedures. Under the new rule, which has an effective date of August 6, 2004, the Commission "will calculate the amount of fees and assessments due based on the volume of these transactions and bill the exchange or association that amount." In addition to the Final Rule, the Commission has adopted a temporary rule, effective from August

6, 2004 until January 1, 2005, that will enable it to calculate Section 31 fees and assessments using the new procedures for the whole of its fiscal year 2004.

#### SEC IV: SEC Issues Final Disclosure Rule Regarding Approval of Investment Advisory Contracts

U.S. Securities and Exchange Commission, [Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies](#), Release Nos. 33-8433, 34-49909, IC-26486 (June 23, 2004).

On June 23, the Commission adopted rule and form amendments under the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940 to enhance disclosures provided by registered management investment companies "about how their boards of directors evaluate and approve, and recommend shareholder approval of, investment advisory contracts." According to the adopting release:

"The amendments require a registered management investment company to provide disclosure in its reports to shareholders regarding the material factors and the conclusions with respect to those factors that formed the basis for the board's approval of advisory contracts during the most recent fiscal half-year. The amendments also are designed to encourage improved disclosure in proxy statements regarding the basis for the board's recommendation that shareholders approve an advisory contract."

The disclosure enhancements provided for under the newly-adopted rule address issues including the following:

*Selection of Adviser and Approval of Advisory Fee* - The amendments "clarify" that a fund's discussion of this topic "must include factors relating to

both the board's selection of the investment adviser, and its approval of the advisory fee and any other amounts to be paid under the advisory contract."

*Specific Factors* - The amendments require funds to include discussions including, but not limited to, the following topics: (1) the nature, extent and quality of the services to be provided by the investment adviser; (2) the investment performance of the fund and the investment adviser; (3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; (4) the extent to which economies of scale would be realized as the fund grows; and (5) whether fee levels reflect these economies of scale for the benefit of fund investors. (Note: In its final version of the rule, the Commission added an instruction to clarify that "if any of the enumerated factors is not relevant to the board's evaluation of an investment advisory contract, the discussion must note this and explain the reasons why that factor is not relevant.")

*Comparison of Fees and Services Provided by Adviser* - Funds will now be required to indicate "whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (*e.g.*, pension funds and other institutional investors). If the board relied upon such comparisons, the discussion will be required to describe the comparisons that were relied on and how they assisted the board in concluding that the contract should be approved."

*Evaluation of Factors* - The existing SAI and proxy statement requirements, according to the Commission, make clear that conclusory statements or a list of factors will not be considered sufficient disclosure and that "a fund's discussion must relate to the factors to the specific circumstances of

the fund and the investment advisory contract." The SEC's adopting release makes clear that funds must provide discussion stating "how the board evaluated each factor".

## **SEC V: SEC Adopts Changes to Short Sale Rules**

U.S. Securities and Exchange Commission, [SEC Adopts Changes to Short Sale Rules, Disclosures Regarding Advisory Contract Approval and Investment Company Governance Provisions](#), News Release 2004-87 (June 23, 2004).

On June 23, the U.S. Securities and Exchange Commission voted to adopt new Regulation SHO under the Exchange Act. Although as of this writing the Commission has not yet made the adopting release available, the Commission's announcement says that the new regulation will include the following:

- "Rule 202(T), which establishes procedures to allow the Commission to temporarily suspend the operation of the current 'tick' test in Rule 10a-1, and any short sale price test of any exchange or national securities association, for specified securities.
- Through a separate order, the Commission will suspend, on a pilot basis for a period of one-year, the tick test provision of paragraph (a) of Rule 10a-1, and any short sale price test of any exchange or national securities association, for approximately one-third of stocks in the Russell 3000 index.
  - The order also will suspend, on a pilot basis for a period of one year, the tick test provision of paragraph (a) of Rule 10a-1 for short sales executed in any security included in the Russell 1000 index after 4:15 p.m. Eastern, and all other securities after the close of

the consolidated tape, and until the open of the consolidated tape the next day.

- The pilot will commence on January 3, 2005 to permit broker-dealers and [SROs] to make the necessary programming adjustments. . . .

Rule 203, which will incorporate current Rule 10a-2 and will create a uniform Commission rule requiring broker-dealers, prior to effecting short sales in all equity securities, to 'locate' securities available for borrowing.

- There will be limited exceptions from the locate requirement, including for short sales by registered market makers in connection with bona-fide market making.
- Rule 203 also imposes additional requirements on designated 'threshold securities.' Rule 203 defines a threshold security to mean an equity security for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more and that is equal to at least 0.5% of the issue's total shares outstanding.
- Where a clearing agency participant has a fail to deliver position in threshold securities that persists for ten consecutive days after settlement, the participant must take action to close out the position. Until the position is closed out, the participant, and any broker-dealer for which it clears transactions, may not effect further short sales in the particular threshold security without borrowing or entering into a bona fide arrangement to borrow the security."

Interestingly, the Commission put off consideration of its proposal to replace the current tick test of Rule 10a-1 with a new uniform bid test, although it notes that it "could reconsider" after completion of the pilot. The Commission also amended Rule 105 under Regulation M to remove the current shelf offering exception and issued interpretive guidance addressing "sham transactions" designed to evade the rule, saying that the amendment applies to all short sales effected within five days prior to the pricing of a shelf offering. Such short sales may not be covered with offering securities purchased from an underwriter or other broker-dealer participating in the offering.

## **SEC VI: SEC Adopts Rule Amendments To Improve Governance of Investment Companies and Independence of Fund Directors**

U.S. Securities and Exchange Commission, [SEC Adopts Changes to Short Sale Rules, Disclosures Regarding Advisory Contract Approval and Investment Company Governance Provisions](#), News Release 2004-87 (June 23, 2004).

During its rather busy June 23 meeting, the Commission voted to adopt rule amendments to improve the governance of investment companies (funds) and the independence of fund directors. Once again, as of this writing, the Commission has not yet made the adopting release available, but its announcement indicates that amendments to certain exemptive rules under the Investment Company Act would include the following:

*Independent Composition of the Board* - At least 75 percent of the fund's board will now have to be independent directors. An exception will allow three-member boards to have all but one director be independent.

*Independent Chairman* - Fund boards now will be required to appoint an independent director as chairman.

*Annual Self-Assessment* - Fund boards will be required to assess their own effectiveness at least once a year. Such assessments must include consideration of the board's committee structure and the number of funds on whose boards the directors serve.

*Separate Meetings of Independent Directors* - The independent directors are required to meet in separate sessions at least once a quarter.

*Independent Director Staff* - Funds now must authorize independent directors to hire their own staff.

#### **SRO I: Reminder to NASD Members That Deadline for Adopting Business Continuity Plans Is Fast Approaching**

[Order Approving Proposed Rule Changes of National Association of Securities Dealers, Inc. and New York Stock Exchange, Inc. Relating to Business Continuity Planning of Members and Notice of Filing and Order Granting Accelerated Approval of NASD Amendment Nos. 6, 7 and 8 \(Apr. 7, 2004\).](#)

On April 7, 2004, the U.S. Securities and Exchange Commission entered an order approving proposed NASD and NYSE rules changes relating to business continuity planning of their members. NASD members should be aware of the following:

On or before August 11, clearing members must comply with the NASD's requirements that they adopt a written business continuity plan.

Introducing members must adopt their written business continuity plans is

September 10.

## **PCAOB I: PCAOB's Internal Controls Standards Approved by SEC**

[SEC Order Approving \[PCAOB's\] Proposed Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements](#), Release No. 34-49884 (June 17, 2004).

U.S. Securities and Exchange Commission, [FAQs - Office of the Chief Accountant, Division of Corporation Finance: Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reporting and Disclosure in Exchange Act Periodic Reports Frequently Asked Questions](#) (June 22, 2004).

Public Company Accounting Oversight Board, [FAQs - Staff Questions and Answers: Auditing Internal Control Over Financial Reporting](#) (June 23, 2004).

On June 17, the SEC issued a release approving the Public Company Accounting Oversight Board Standard No. 2 entitled "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements". Auditing Standard No. 2, in effect, provides the professional standards and related performance guidance for independent auditors to attest to, and report on, management's assessment of the effectiveness of internal control over financial reporting under Section 404 of Sarbanes-Oxley. Almost immediately, the staffs of both the Commission and the PCAOB released FAQs designed to provide guidance regarding the new standard. Links to both sets of FAQs are available above.

## **PCAOB II: PCAOB Adopts Auditing Standard No. 3: Audit Documentation**

Public Company Accounting Oversight Board, [Audit Documentation and Amendment to Interim Auditing Standards](#), PCAOB Release No. 2004-006 (June 9, 2004).

On June 9, the Public Company Accounting Oversight Board adopted Auditing Standard No. 3: Audit Documentation. The principal objective of the standard is to improve the quality of audits and other engagements by requiring auditors to document procedures performed, evidence obtained and conclusions reached. The adopting release provides guidance regarding the following:

- Auditors' obligation to document their work.
- The requirement that experienced auditors must understand the work.
- The importance of the report release date and the documentation completion date.
- Subsequent changes to audit documentation.
- Documentation deficiencies.
- Multi-location audits.
- Parts of audits performed by others.
- Retention of audit documentation for seven years.

### **PCAOB III: PCAOB Adopts Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms**

Public Company Accounting Oversight Board, [Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms](#), PCAOB Release No. 2004-005 (June 9, 2004).

Also on June 9, the Public Company Accounting Oversight Board adopted rules related to the oversight of non-U.S. accounting firms: PCAOB Rules 4011, 4012, 5113, 6001 and 6002, plus related definitions.

Rules 4011 and 4012 deal with inspections and provide a foreign registered public accounting firm an opportunity to minimize the unnecessarily duplicative administrative burdens of dual oversight by requesting that the PCAOB may rely -- to an extent deemed appropriate by the PCAOB -- on inspections of the

registered firm under the home country's oversight system. The PCAOB's rule on investigations (Rule 5113) provides that the Board may, in appropriate circumstances, rely on the investigation or sanction, if any, of a foreign registered public accounting firm by a non-U.S. authority. The PCAOB also adopted two rules "reflecting its willingness to assist non-U.S. authorities in their oversight of firms located in the U.S. and registered with the Board." According to the PCAOB's adopting release, "PCAOB Rule 6001 relates to inspections and provides that the Board may, as it deems appropriate, assist a non-U.S. authority in its inspection of a registered U.S. firm. PCAOB Rule 6002 relates to investigations and provides that the Board may, as it deems appropriate and to the extent permitted by law, assist a non-U.S. authority in the investigation of a registered U.S. accounting firm."

#### **DELAWARE CHANCERY COURT: Court Issues Decision Addressing Undisclosed Merger Negotiations**

[Alessi v. Beracha, C.A. No. 18993-NC, 2004 WL 1052389 \(Del. Ch., May 11, 2004\)](#). NOTE: You will need your Westlaw password information to access this copy of the decision.

On May 11, the Delaware Chancery Court refused to dismiss a shareholder's complaint against the directors of Earthgrains Company that had chosen not to disclose confidential merger negotiations with Sara Lee Corporation while a company sponsored odd-lot stock purchase program was in effect.

The merger negotiations began in the midst of Earthgrain's buy-sell program designed to allow odd-lot shareholders to buy or sell shares at current market values "for a below normal brokerage fee". Plaintiff, Margaret Alessi, sold her shares shortly before a public announcement that Sara Lee had agreed to purchase Earthgrains for nearly twice the market price of the company's shares. She sued Earthgrain and its directors.

The Court rejected the request of the company and its directors to dismiss the

action on the ground that the defendants did not have a fiduciary duty to disclose confidential merger negotiations.

The decision, which addresses a host of other interesting issues, is the subject of an excellent memorandum by Kirkland & Ellis LLP available in the Special Features section of the home page of [RealCorporateLawyer.com](http://RealCorporateLawyer.com).

### **PRACTICAL GUIDANCE: Courtesy of RealCorporateLawyer.com**

Every day RealCorporateLawyer.com works hard to provide its readers with free access to a very large collection of law firm memoranda providing practical guidance on current hot topics. Readers are encouraged to visit the frequently-updated "Special Features" area of the home page for such current memoranda, as well as the [SEC Reform Portal](#) containing hundreds of other such memoranda. Recent additions include:

<a href="#">M&amp;A Notes from Kirkland &amp; Ellis LLP</a> (06/23/04)	<a href="#">SEC Approves PCAOB Auditing Standard on Internal Control Over Financial Reporting; Announces Additional Implementation Guidance to Follow from Gibson, Dunn &amp; Crutcher LLP</a> (06/22/04)
<a href="#">Disclosure: Ten Key Requirements in the SEC's ABS Release from Kirkland &amp; Ellis LLP</a> (06/23/04)	<a href="#">Proposed Interagency Statement on Complex Structured Finance Activities from Thacher, Proffitt &amp; Wood LLP</a> (06/22/04)
<a href="#">Accounting Treatment of Stock-Based Compensation Arrangements Due to Change in 2005 from Snell &amp; Wilmer LLP</a> (06/23/04)	<a href="#">Deferred Compensation Legislation Goes To Conference - Significant Grandfather Issues Remain from Mayer, Brown, Rowe &amp; Maw LLP</a> (06/18/04)

In addition, RealCorporateLawyer.com is constantly updating its FAQs on important issues. This month a new set of [Electronic Discovery FAQs](#) have been added.

Also, don't forget the new [RealFundCompliance.com](http://RealFundCompliance.com) Web site. The free site includes a [monthly E-Zine](#) on fund compliance as well as [breaking news](#) on fund compliance issues. There are [daily regulatory developments listings](#) on the home page as well as hot topic sections on such topics as [compliance](#), [disclosure](#), [fund governance](#), [soft dollars](#), [revenue sharing](#), [frequent trading](#) and [legislative initiatives](#). The site includes a new [FAQ section](#) as well as special features on topics including the following: [anti-money laundering](#), [bank/trust companies](#), [broker-dealers](#), [CFTC](#), [ERISA / fiduciary](#), [inspection / enforcement](#),

[insurance products](#), [investment advisers](#), [litigation](#), [private funds / hedge funds](#), [registered funds](#), [retirement / 529 plans](#), and [Sarbanes-Oxley](#).

### **COMINGS AND GOINGS: Who's Doing and Saying What and Where?**

On July 1 the SEC announced that **Charles Fishkin** has been named Director of the Commission's new Office of Risk Assessment. Mr. Fishkin, who most recently served as vice president of Firmwide Risk at Fidelity Investments in Boston, will manage the Commission's overall risk assessment program, will coordinate risk assessment activities and will report directly to SEC Chairman **William H. Donaldson**. See [Charles Fishkin Named Director of SEC's New Office of Risk Assessment; Director To Coordinate Initiative Launched by Chairman in 2003](#), News Release 2004-92 (July 1, 2004).

**Merri Jo Gillette** has been named Regional Director of the SEC's Midwest Regional Office according to an announcement issued by the SEC on June 8. Ms. Gillette has served as the Associate District Administrator for Enforcement in the Commission's Philadelphia Office. She succeeds **Mary Keefe**, the former Regional Director, who has taken a position in the private sector. See U.S. Securities and Exchange Commission, [Merri Jo Gillette Named Regional Director of the SEC's Midwest Regional Office](#), News Release No. 2004-79 (June 8, 2004).

**Mark K. Schonfeld** has been appointed Regional Director of the SEC's Northeast Regional Office according to a News Release issued by the SEC on June 8. He succeeds **Wayne Carlin**, the former Regional Director, who is now in private practice. Mr. Schonfeld formerly served as one of two Associate Regional Directors for Enforcement in the Northeast Regional Office. See U.S. Securities and Exchange Commission, [Mark K. Schonfeld Named Regional Director of SEC's Northeast Regional Office](#), News Release 2004-78 (June 8, 2004).

**What Are the Commissioners Saying?** SEC Commissioner **Paul S. Atkins** delivered a [Statement Regarding Investment Company Governance Proposal](#) at the Commission's June 23 open meeting. At the same open meeting, SEC Commissioner **Cynthia A. Glassman** also delivered a [Statement Regarding](#)

[Investment Company Governance Proposal](#). SEC Chairman **William H. Donaldson**, on June 20, delivered "[Remarks from Directors College at Stanford University Law School](#)" regarding the SEC's recent accomplishments and issues of corporate governance. On June 18, SEC Commissioner **Cynthia A. Glassman** delivered a speech entitled "[The SEC's Role as Functional Regulator of Bank Securities Activities](#)." Commissioner Glassman also delivered "[Remarks Before the National Association for Variable Annuities](#)" on June 14. During the Commission's June 2 open meeting, Chairman **William H. Donaldson** delivered a [Speech Regarding the Gramm-Leach-Bliley Act Bank Broker Rules](#). Chairman Donaldson also delivered the [Baruch College Commencement](#) on June 1.

**What Are the Commission Staffers Saying?** On June 30, **Lori A. Richards** spoke before the ICI / IDC Mutual Fund Compliance Programs Conference regarding "[The New Compliance Rule: An Opportunity for Change](#)". On June 24, the SEC's Chief Accountant, **Donald T. Nicolaisen**, participated in an "Open Roundtable Discussion with Respondents to the Financial Accounting Standards Board Exposure Draft, Share-Based Payment". On June 18 SEC Staffer **Catherine McGuire** spoke before the Conference on the SEC's Bank Broker-Dealer Rule sponsored by The Morin Center for Banking and Financial Law of Boston University School of Law regarding "[An Overview of Proposed Regulation B](#)". On June 15, **Mary Ann Gadziala** delivered "[Remarks before NAVA's 2004 Regulatory Affairs Conference](#)". The day before, at the same conference, the SEC's Director of the Division of Investment Management, **Paul F. Roye**, delivered "[Remarks Before the NAVA Regulatory Affairs Conference](#)". On June 3, the SEC's Chief Accountant, **Donald T. Nicolaisen**, delivered "[Remarks Before the Public Hearing on the IASC Constitution Review](#)". Also on June 3, the SEC's General Counsel, Giovanni P. Prezioso, delivered "[Remarks Before the American Bar Association Section of Business Law, General Counsel Forum](#)".

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