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FSA I: FSA Publishes Policy Statement and Near Final Rules on Implementation of Prospectus Directive

Financial Services Authority, [Implementation of the Prospectus Directive - Feedback on CP04 / 16 and CP05 / 7 and Near Final Prospectus Rules](#), PS05/7 (June 6, 2005).

Financial Services Authority, [Newsletter Providing Summary of PS05/7](#) (June 6, 2005).

Financial Services Authority, [FSA Publishes Near Final Prospectus](#)

[Directive Rules](#), Press Release (June 6, 2005).

On June 6, the U.K.'s Financial Services Authority published its policy statement (PS05/7) and near final rules on the implementation of the Prospectus Directive. According to the FSA, this publication means that the U.K. is "on track to implement the Prospectus Directive, along with the Market Abuse Directive and revised Listing regime, on 1 July."

The new rules will apply to prospectuses for public offers of securities and listing of securities on a regulated market. According to the FSA, the "key" provisions of the directive are:

Prospectus Requirements – prescribing the contents and format of prospectuses; allowing issuers to incorporate by reference; allowing the use of three part prospectuses; setting out the exemptions from the requirement to produce prospectuses;

Approval and Publication of prospectus – setting out procedures for approval or prospectuses and how and where they must be published;

Passport Rights – introduces administrative measures to facilitate the passporting of prospectuses on a pan-European basis making it easier for companies to raise capital across Europe;

Third Country Issuers – prospectuses drawn up under a third country's law can be treated as equivalent to directive requirements. This will be determined on a case-by-case basis; and

Other Provisions – requiring issuers to produce annual information updates and the establishment of a qualified investors register.

SEC I: SEC Publishes 523-Page Adopting Release for Regulation NMS and Strong Dissent by Two Commissioners

U.S. Securities and Exchange Commission, [Final Rules and Amendments to Joint Industry Plans](#), Release No. 34-51808 (June 9, 2005).

U.S. Securities and Exchange Commission, [Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the](#)

[Adoption of Regulation NMS](#) (June 9, 2005).

On June 9, the U.S. Securities and Exchange Commission published its adopting release for the Regulation NMS rules and amendments to the joint industry plans for disseminating market information. Regulation NMS includes new substantive rules that, according to the SEC, "are designed to modernize and strengthen the regulatory structure of the U.S. equity markets." The SEC says:

"First, the 'Order Protection Rule' requires trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotation displayed by other trading centers, subject to an applicable exception. To be protected, a quotation must be immediately and automatically accessible. Second, the 'Access Rule' requires fair and non-discriminatory access to quotations, establishes a limit on access fees to harmonize the pricing of quotations across different trading centers, and requires each national securities exchange and national securities association to adopt, maintain, and enforce written rules that prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross automated quotations. Third, the 'Sub-Penny Rule' prohibits market participants from accepting, ranking, or displaying orders, quotations, or indications of interest in a pricing increment smaller than a penny, except for orders, quotations, or indications of interest that are priced at less than \$1.00 per share. Finally, the Commission is adopting amendments to 'Market Data Rules' that update the requirements for consolidating, distributing, and displaying market information, as well as amendments to the joint industry plans for disseminating market information that modify the formulas for allocating plan revenues . . . and broaden participation in plan governance".

Perhaps most intriguing, Commissioners Cynthia A. Glassman and Paul S. Atkins filed a [44-page dissent](#) emphasizing their "strong disagreement with the majority's adoption of Regulation NMS" and noting that although they support the goal of enhancing the efficacy of the markets, they "do not believe, however, that Regulation NMS will achieve this goal, and we are concerned about its

detrimental impact on competition and innovation." To make matters more interesting, the [adopting release](#) includes Section XII entitled "Response to Dissent" (pages 403-433) responding to the dissenters' allegation that the Commission's "statutory interpretations and policy changes are arbitrary, unreasonable and anticompetitive" and that they are "not supported by substantial evidence that, notwithstanding their anti-competitive effect, they are necessary or appropriate to further the purposes of the Exchange Act." If nothing else, the dissent and the Commission's reply to that dissent make interesting reading and provide insight into the factions that battled behind the scenes over adoption of Regulation NMS.

SEC II: Commission Begins Making Comment Letters Available Online

U. S. Securities and Exchange Commission, [SEC Staff To Begin Publicly Releasing Comment Letters and Responses](#), News Release 2005-72 (May 9, 2005).

U. S. Securities and Exchange Commission, [How To Search for EDGAR Correspondence](#) (June 8, 2005).

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

On May 12, Commission staffers began making available via the EDGAR database comment and response letters relating to disclosure filings made after August 1, 2004 and reviewed by the Division of Corporation Finance and the Division of Investment Management. The move followed an [announcement of the program](#) nearly one year in which the Commission also provided background information regarding what materials are being released, timing and confidential treatment.

On June 8, 2005 the Commission released instructions on "[How to Search for EDGAR Correspondence](#)" noting that there are several methods to search for

these new correspondence materials. The Commission noted that the new letter form types are "upload" (for SEC-originated letters) and "corresp" (for filer response letters outside of amended filings). In its instructions on how to search for such comment and response letters, the Commission's guidance provides tips on performing: (1) a historical archive search; (2) a company search; or (3) a review of the EDGAR indexes to find such materials.

To view examples of the comment and response letters now available in the EDGAR database, [click here](#).

SEC III: Commission Releases a Staff Statement on Management's Report on Internal Control Over Financial Reporting

U. S. Securities and Exchange Commission, [Staff Statement on Management's Report on Internal Control Over Financial Reporting](#) (May 16, 2005).

U. S. Securities and Exchange Commission, [Commission Statement on Implementation of Internal Control Reporting Requirements](#) (May 16, 2005).

On May 16, the Commission released a statement on the implementation of internal control reporting requirements. The statement referenced the Commission's April 13th Roundtable on Implementation of Internal Control Reporting Provisions and feedback submitted in response to the Commission's request for such material issued in conjunction with the Roundtable. According to the Commission, "we believe two messages came through clearly: First, compliance with Section 404 is producing benefits, including a heightened focus on internal controls at the top levels of public companies. . . . Second, implementation in the first year also resulted in significant costs." Perhaps most significantly for those who must deal with Section 404 reporting issues, the Commission admitted in its statement that "some non-trivial costs may have been unnecessary, due to excessive, duplicative or misfocused efforts."

As a consequence of such feedback, the Commission asked the SEC staff to consider whether additional guidance and clarification of certain issues was appropriate. On May 16, the Commission released the staff's report, entitled: ["Staff Statement on Management's Report on Internal Controls Over Financial Reporting."](#)

According to the Commission, based on the feedback it received and the Staff Statement released by the Division of Corporation Finance and the Office of the Chief Accountant, there are several broad concepts that "bear mention at this time". According to the Commission:

Although it is not surprising that first-year implementation of Section 404 was challenging, almost all of the significant complaints we heard related not to the Sarbanes-Oxley Act or to the rules and auditing standards implementing Section 404, but rather to a mechanical, and even overly cautious, way in which those rules and standards apparently have been applied in many cases. Both management and external auditors must bring reasoned judgment and a top-down, risk-based approach to the 404 compliance process. A one-size fits all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve internal controls and financial reporting than reasoned, good faith exercise of professional judgment focused on reasonable, as opposed to absolute, assurance.

In future years we expect the internal control audit to be better integrated with the audit of a company's financial statements. If management and auditors can achieve the goal of integrating the two audits, we expect that both internal and external costs of Section 404 compliance will fall for most companies.

Internal controls over financial reporting should reflect the nature and size of the company to which they relate. Particular attention should be paid to making sure that implementation of Section 404 is appropriately tailored to the operations of smaller companies. Again, this is an area where reasoned judgment and a risk-based approach must be brought to bear. We continue to be actively engaged in projects to evaluate and assess the effects of the internal control reporting rules on smaller companies. In addition to delaying the implementation of those rules for smaller companies, we have encouraged the Committee of Sponsoring Organizations (COSO) of the Treadway Commission to develop additional guidance in applying its internal control framework to smaller companies. We have established the Commission Advisory Committee on Smaller Public Companies to consider the impact of Commission rules - including the internal control reporting rules - on smaller companies.

We encourage frequent and frank dialogue among management, auditors and audit committees with the goal of improving internal controls and the financial reports upon which investors rely. Management of all companies - large and small - should not fear that a discussion of internal controls with, or a request for assistance or clarification from, the auditor will, itself, be deemed a deficiency in internal control. Moreover, as

long as management determines the accounting to be used and does not rely on the auditor to design or implement the controls, we do not believe that the auditor's providing advice or assistance, in itself, constitutes a violation of our independence rules. Both common sense and sound policy dictate that communications must be ongoing and open in order to create the best environment for producing high quality financial reporting and auditing; communications must not be so restricted or formalized that their value is lost.

SEC IV: SEC Fee Rate Advisory Clarifies Fees for 2006 Will Decrease to \$107 Per Million

U. S. Securities and Exchange Commission, [Fee Rate Advisory #1 For Fiscal Year 2006](#).

The SEC has released Fee Rate Advisory #1 for Fiscal Year 2006. The advisory provides that on the later of either October 1, 2005 or five days after the date on which the Commission receives its fiscal year 2006 regular appropriation, the Section 6(b) fee rate applicable to the repurchase of securities, the Section 13(e) fee rate applicable to the repurchase of securities, and the Section 14(g) fee rates applicable to proxy solicitations and statements in corporate control transactions will decrease to \$107.00 per million from the current rate of \$117.70 per million. On the same date, the Section 31 fee rate applicable to securities transactions on the exchanges and certain over-the-counter markets will decrease to \$30.70 per million from the current rate of \$41.80 per million.

SEC V: SEC Must Close a \$48 Million Funding Shortfall After Misjudging Costs for New Headquarters and Other Offices

In mid-May, the Commission suffered the indignity of stinging barbs from the media when news outlets reported that the Commission would have to close a \$48 million funding shortfall "after misjudging security and construction costs at its new Washington headquarters and offices in New York and Boston."

Schmidt, Robert, [SEC Books Show \\$48M Shortfall](#), Bloomberg News special to [New York] Daily News (May 25, 2005). Apart from the embarrassment that the media questioned the Commission's own internal controls, the Commission

reportedly will have to deal with an investigation into the shortfall by the GAO. Reports quoted a senior aide to Chairman Donaldson saying that "the SEC won't seek additional money from Congress. Instead, the agency has told employees to limit travel, as part of an effort to slash nonessential costs, and will slow hiring and find other savings to prevent the shortfall from eating into enforcement and investor protection." *Id.*

SEC VI: SEC Files Settled Actions Charging National Stock Exchange and its CEO with Failure to Enforce Exchange Rules

U.S. Securities and Exchange Commission, [SEC Sues David Colker, CEO of National Stock Exchange, For Aiding and Abetting The Exchange's Failure To Enforce Its Rules](#), Litig. Release No. 19229 (May 19, 2005).

U.S. Securities and Exchange Commission, [SEC Charges National Stock Exchange and its CEO, David Colker, for Failure To Enforce Exchange Rules -- NSX Consents to Censure, Cease-and-Desist Order, Structural Overhaul to Insulate Regulatory Functions, Retention of Consultant, and \\$1 Million Fund for Regulatory Auditor -- Colker Consents to Censure and \\$100,000 Penalty](#), News Release No. 2005-79 (May 19, 2005).

On May 19, the SEC announced the settlement of an unusual enforcement action against the National Stock Exchange and its CEO, David Colker. The Commission alleged that NSX violated Exchange Act Section 19(g) by failing "until 2004" to conduct surveillance for violations of its customer priority rule that prohibited NSX dealers from trading securities for their own accounts ahead of marketable customer orders. According to the Commission: "As a result, NSX failed to detect hundreds of thousands of transactions in which NSX dealers traded ahead of customer orders."

The Commission also alleged that NSX and David Colker did not enforce the

Exchange's market order exposure rule "in a manner consistent with the rule's language." According to the Commission's announcement:

"The MOE rule required NSX dealers to provide customer market orders with the opportunity for price improvement whenever the spread between the national best bid and offer was greater than the minimum price variation. In 1997, when the minimum price variation decreased from 1/8 to 1/16 of a point, NSX continued enforcing the rule at spreads of 1/4 point or greater instead of at 1/8 point or greater. At Colker's direction, NSX did not file a proposed rule amendment with the SEC seeking approval for its limited enforcement of the MOE rule, although NSX was required to do so. Colker made this decision, in part, because he wanted to avoid exposing a proposed rule amendment to a public notice-and-comment process. Consequently, public customers lost opportunities for potential price improvement on thousands of market orders executed on NSX from 1997 to 2003."

NSX and David Colker consented to entry of a variety of relief without admitting or denying the findings in the SEC's order.

PCAOB I: Board Takes First Enforcement Action Revoking Firm's Registration and Disciplining Three Accountants

Public Company Accounting Oversight Board, [Board Revokes Firm's Registration, Disciplines Three Accountants for Failure to Cooperate](#) (May 24, 2005).

Public Company Accounting Oversight Board, [Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions in the Matter of Goldstein and Morris, CPAs, P. C. and Edward B. Morris, CPA](#), PCAOB Release No. 2005-010 (May 24, 2005).

Public Company Accounting Oversight Board, [Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions In the Matter of Alan J. Goldberger, CPA and William A. Postelnik, CPA](#), PCAOB Release No. 2005-011 (May 24, 2005).

On May 24, the Public Company Accounting Oversight Board announced that it has taken its first enforcement action. The action was particularly serious -- revocation of an accounting firm's registration with the board, entry of a bar against the firm's managing partner from association with a registered accounting firm and entry of censures against two former partners of the firm finding that they participated in the misconduct but noting that they promptly alerted the PCAOB and cooperated in the Board's investigation. The facts of the case, as described by the PCAOB news release, seemed particularly egregious. The announcement stated, in part, as follows:

The accounting firm, Goldstein and Morris CPAs, P.C., based in New York City, was notified in September 2004 that the firm would be inspected by the PCAOB in November 2004.

The PCAOB's Division of Registration and Inspections directed a request for information and documents to the firm's managing partner, Edward B. Morris. The Board found that, in responding to the request, Mr. Morris and two partners, Alan J. Goldberger and William A. Postelnik, were aware that the firm had prepared the financial statements of two of its public company audit clients, contrary to auditor independence requirements of federal law. The Board found that Messrs. Morris, Goldberger, and Postelnik took steps to conceal that fact from the Board by omitting certain requested information from the firm's written response to the inspection request.

The Board also found that the partners, after learning of the

imminent inspection, formulated and carried out a plan to create and back-date certain documents and place them in the firm's audit files. The Board found that Messrs. Morris, Goldberger, and Postelnik took these steps to conceal from the Board the firm's failure to comply with certain auditing standards.

Messrs. Goldberger and Postelnik notified the PCAOB of the omitted and falsified information. Both resigned from the firm.

The accounting firm and Mr. Morris consented to a Board order making the findings and imposing sanctions, without admitting or denying the findings. The order bars Mr. Morris from association with a registered accounting firm and revokes the firm's registration. Firms that are not registered with the PCAOB are prohibited from auditing the financial statements of public companies.

Messrs. Goldberger and Postelnik each consented to a Board order making the findings and imposing the censures without admitting or denying the findings. The Board limited the sanctions of the two men to censures because they “promptly and voluntarily brought the matter to the Board's attention, disclosed their own misconduct and the misconduct of others, and made affirmative efforts to provide the Board with relevant information.”

PCAOB II: Board Issues Guidance on Audits of Internal Controls

Public Company Accounting Oversight Board, [Staff Questions and Answers: Auditing Internal Control Over Financial Reporting](#) (May 16, 2005).

Public Company Accounting Oversight Board, [Policy Statement Regarding Implementation of Auditing Standard No. 2, An Audit of](#)

[Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements](#), PCAOB Release No. 2005-009 (May 16, 2005).

Public Company Accounting Oversight Board, [PCAOB Issues Guidance on Audits of Internal Control](#) (May 16, 2005).

On May 16, the PCAOB published additional guidance for auditors regarding how to implement the PCAOB's [Auditing Standard No. 2: "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements"](#).

The guidance consists of two items: a [Board Policy Statement Regarding Implementation of Auditing Standard No. 2](#) and a [Set of FAQs regarding implementation of Auditing Standard No. 2](#). The additional guidance reportedly was prepared in response to questions and concerns raised during the April 13 SEC Roundtable on Implementation of Internal Control Reporting Provisions.

According to the PCAOB:

"the staff questions and answers seek to correct the misimpression that certain provisions of Auditing Standard No. 2 need to be applied in a rigid manner that discourages auditors from exercising the judgment necessary to conduct an internal control audit in a manner that is both effective and cost-efficient. The Policy Statement expresses the Board's view that, to properly plan and perform an effective audit under Auditing Standard No. 2, auditors should –

integrate their audits of internal control with their audits of the client's financial statements, so that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits;

exercise judgment to tailor their audit plans to the risks facing individual audit clients, instead of using standardized "checklists" that may not reflect an allocation of audit work weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas);

use a top-down approach that begins with company-level controls, to identify for further testing only those accounts and processes that are, in fact, relevant to internal

control over financial reporting, and use the risk assessment required by the standard to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement;

take advantage of the significant flexibility that the standard allows to use the work of others; and

engage in direct and timely communication with audit clients when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports."

Litigation I: N.Y. Court of Appeals Imposes Fiduciary Duty on IPO Underwriter Goldman Sachs

[EBC I, Inc. v. Goldman Sachs & Co., No. 61 \(N.Y. Ct. App., June 7, 2005\)](#) (Uncorrected Opinion Subject to Revision Before Publication in the New York Reports).

On June 7, the New York Court of Appeals released its decision in [EBC I, Inc. v. Goldman Sachs & Co.](#) The decision, described by some as a "benchmark" ruling, addresses whether the lead underwriter of an initial public offering owes a fiduciary duty to reveal any pertinent conflicts of interest. In its opinion, the majority noted that:

"Here, the complaint alleges an advisory relationship that was independent of the underwriting agreement. Specifically, plaintiff alleges eToys was induced to and did repose confidence in Goldman Sachs' knowledge and expertise to advise it as to a fair IPO price and engage in honest dealings with eToy's best interest in mind. Essentially, according to the complaint, eToys hired Goldman Sachs to give it advice for the benefit of the company, and Goldman Sachs thereby had a fiduciary obligation to disclose any conflict of interest concerning the pricing of the IPO. Goldman Sachs breached this duty by allegedly concealing from eToys its

divided loyalty arising from its profit-sharing arrangements with clients."

Id., pp. 8-9.

A stinging dissent by Justice Read contends that the majority has expanded the concept of fiduciary duty in such transactions far beyond what current law contemplates and notes that "[i]n allowing plaintiff's claim for breach of fiduciary duty to go forward, the majority disregards that eToys was a sophisticated, well-counseled business entity. eToys' major stockholders included important venture-capital and corporate investors; its largest single stockholder, idealab!, styles itself as an incubator for successful technology companies. . . . eToys was represented by the Venture Law Group, P. C., which 'specializes representing high potential technology companies from before their creation through their public offering or acquisition and beyond,' and which in 1999, handled 'the fourth largest number of initial public offerings for technology companies in the country". Dissent, p. 5.

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M&A Notes regarding supremacy of Delaware law over California law for Delaware corporations, from Kirkland & Ellis. (06/09/05)	Litigation Update: Recent Trends In Securities Litigation. (05/17/05)
M&A Notes regarding continuing director provisions in poison pills, from Kirkland & Ellis. (05/31/05)	Securities Law Update: New OSC Rule Restricts Trading During Distributions, Formal Bids and Share Exchange Transactions from Stikeman Elliott LLP. (05/17/05)

Legal Update: SEC and PCAOB Issue Important Guidance Designed to Lower the Cost of Internal Control Reviews from Morrison and Foerster. (05/24/05)	Final Version of Canadian Corporate Governance Disclosure Rule Adopted from Stikeman Elliott LLP. (04/29/05)
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Please don't forget the latest of the free Spring 2005 SEC "Hot Topics" Seminars where you will hear from SEC officials, corporate counsel, law firm partners, finance professionals and accounting experts on the hottest SEC topics of the day. The complimentary seminar, for which CLE/CPE credit is available, will be held in Philadelphia (June 16). Similar seminars recently have been held in Houston (May 17), Washington, D.C. (May 19) and Seattle (June 7). For more information, please visit the [seminar home page](#) and review the [registration page](#), the [program overview page](#), the [program agenda](#), and the [faculty list](#). You also can register online for the Seventh Annual SEC Disclosure, Accounting and Enforcement Conference at the Hyatt Regency San Francisco June 14-15. To learn more and to register online, [click here](#).

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

On June 1, the U.S. Securities and Exchange Commission Chairman **William H. Donaldson** announced that he will step down on June 30, 2005. *See* U.S. Securities and Exchange Commission, [SEC Chairman William H. Donaldson To Step Down on June 30](#), News Release 2005-82 (June 1, 2005). The following day, **President George W. Bush** nominated **Congressman Christopher Cox** of California to replace Chairman Donaldson. *See* Office of The President of the United States, [President Nominates Congressman Chris Cox as SEC Chairman](#) (June 2, 2005).

On June 9, the Board of Directors of the New York Stock Exchange appointed **Mark H. Wille** Vice President, Market Development, effective immediately. Mr. Wille report to **Louis G. Pastina**, Senior Vice President of Market Development and Product Manager for the Hybrid Market. *See* [New York Stock Exchange, NYSE Appoints Mark H. Wille Vice President, Market Development](#) (June 9, 2005).

On May 12, the Commission named **Linda Chatman Thomsen** Director of the Division of Enforcement. She succeeds **Stephen M. Cutler** who announced in April he will leave the Commission. *See* U.S. Securities and Exchange Commission, [Linda Chatman Thomsen Named Director of the Division of Enforcement](#), News Release No. 2005-73 (May 12, 2005).

What Are the Commissioners Saying? On May 19, SEC Chairman **William H. Donaldson** delivered "[Remarks Before the Council on Foreign Relations](#)". On May 12, SEC Chairman **Donaldson** also delivered "[Remarks Before the Foundation Financial Officers Group Spring Meeting](#)". Chairman **Donaldson** also delivered remarks, on May 8, at the [2005 CFA Institute Annual Conference](#).

What Are the Commission Staffers Saying? On June 9, the SEC's Chief Economist, **Chester Spatt**, spoke at a conference in Pittsburgh on the topic "[Governance, the Board and Compensation](#)". On June 2, the SEC's Chief Accountant, **Donald T. Nicolaisen**, delivered "[Remarks Before the USC Leventhal School of Accounting: SEC Financial Reporting Institute Conference](#)". **Annette L. Nazareth**, Director of the SEC's Division of Market Regulation, delivered "[Remarks Before the SIA Market Structure Conference](#)" on May 20. **Annette L. Nazareth** also delivered "[Remarks Before the 2003 Options Industry Conference](#)" on May 13. **Elizabeth King**, Associate Director of the SEC's Division of Market Regulation, delivered "[Remarks Before the 2003 Options Industry Conference](#)" on May 13, 2005. The SEC's **Chester Spatt** also spoke on "[Conflicts of Interest in Asset Management](#)" on May 12. On May 6, the SEC's **Chester Spatt** delivered remarks regarding "[Broad Themes in Market Microstructure](#)". On May 5, **Gene**

Gohlke, an associate director of OCIE at the SEC, spoke at the Managed Funds Association Educational Seminars Series 2005 regarding "[Practice Guidance for Hedge Fund CCOs Under the SEC's New Regulatory Framework.](#)"

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