

SEC CHAIRMAN COMMENTS ON INCREASED EXECUTIVE COMPENSATION DISCLOSURE

In a recent radio interview, SEC Chairman Christopher Cox said better disclosure of executive pay packages should be available to investors and suggested that the SEC will make changes in its disclosure rules, for example, to provide shareholders with a single number that aggregates the



Exactly what “fair” executive compensation is has been the subject of much controversy

various kinds of executive compensation and which will allow for easier comparisons among companies. Chairman Cox said that investors need access to such information in a timely manner so that they can discipline corporate boards that grant compensation packages they view as excessive.

The SEC has been focusing on strengthening executive compensation disclosure for several years, especially in light of the controversies over large severance packages paid to former NYSE Chairman Richard Grasso and former Walt Disney Company President Michael Ovitz.

The Ovitz payout led to a recently dismissed shareholder lawsuit alleging that the board of directors breached their fiduciary duties and committed waste. A Delaware court ruled that the directors were not liable, although the decision noted that their conduct “fell

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significantly short of the best practices of ideal corporate governance.” Also, the court noted that best practices in corporate governance includes compliance with fiduciary duties, but that the reverse is not necessarily true.

In light of the continued focus on executive compensation, boards of directors should comply with best practices in corporate governance when determining executive compensation and consider that the required level of disclosure for executive compensation may continue to increase.■

THE SEC CLEARS UP SECTION 16 AMBIGUITY

On August 3, the Securities and Exchange Commission adopted amendments to its rules under Section 16 of the Securities Exchange Act of 1934 in response to what the SEC viewed as a misinterpretation of these rules in a 2002 decision by a federal circuit court. Section 16(b) is designed to curb abuses of inside information by insiders, and it provides the issuer or shareholders suing on behalf of the issuer a private right of action to recover from an insider any profit realized by the insider from the purchase and sale of any equity security of the issuer within any period of less than six months.

SEC rules create various exemptions to the general prohibition on short swing sales, including Rule 16b-3 for transactions with the issuing company itself and 16b-7 for mergers, reclassifications and consolidations. The SEC amended Rules 16b-3 and 16b-7 to overcome ambiguities caused by the holding in *Levy v. Sterling Holding Company, LLC* which require

the satisfaction of conditions that were neither contained in the text of the rules nor intended by the SEC. This holding, in the SEC’s view, made it difficult for issuers and insiders to plan legitimate transactions.

The amendment to Rule 16b-3 explicitly states that “a transaction need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory

“WE [THE SEC] ARE CLARIFYING OUR OWN RULE AND RESOLVING ANY AMBIGUITY THAT MIGHT EXIST.”
-THE SEC, IN RELEASE NO. 33-8600

element”, if any one of the rule’s three alternative conditions is satisfied. The SEC amended Rule 16b-7 to replace the words “merger or consolidation” with the phrase “merger, reclassification, or consolidation”. In each case the amendments were

designed to overcome holdings by the *Levy* court.

In addition, the SEC also amended Item 405 of Regulations S-K and S-B to rescind the current presumption that a Section 16 report, such as a Form 4, received by the issuer within three calendar days of the required filing date was filed with the SEC by the required filing date.

Because they merely clarify existing rules, the amendments to Rules 16b-3 and 16b-7 are effective when published in the Federal Register and are available for transactions effected on or after the dates of the passage of the original rules in 1996 and 1991, respectively. The amendment to Item 405 is effective 30 days after publication in the Federal Register.

It is important to review your company’s policies to ensure that they are consistent with these interpretations of Section 16.■

FORMER KMART EXECUTIVES CHARGED WITH FRAUD

The Securities and Exchange Commission (SEC) recently filed charges against two former Kmart executives for misleading investors about Kmart's financial condition in the months preceding the company's bankruptcy.

According to the allegations, the defendants failed to disclose the real reasons for Kmart's massive inventory overbuy in 2001 and the impact that it had on the company's liquidity in the Management's Discussion and Analysis (MD&A) section of Kmart's Form 10-Q for the third quarter of 2001. For example, the MD&A falsely attributed increases in inventory to "seasonal inventory fluctuations and actions taken to improve our overall in-stock position," when in fact a significant portion of the inventory buildup was caused by a Kmart officer's "reckless" and "unilateral"

purchase of \$850 million of excess inventory. This purchase in turn led to liquidity problems for Kmart, which then caused Kmart to slow down payments to vendors, many of whom then stopped shipping inventory to Kmart. The defendants allegedly lied about why Kmart's vendors were not being paid on time and misrepresented the impact that Kmart's liquidity

"THE SEC HAS REPEATEDLY EMPHASIZED THE IMPORTANT ROLE MD&A DISCLOSURE IS INTENDED TO PLAY IN GIVING SHAREHOLDERS THE ABILITY TO EXAMINE A CORPORATION 'THROUGH THE EYES OF MANAGEMENT.' KMART SENIOR MANAGEMENT DEPRIVED ITS SHAREHOLDERS OF THAT OPPORTUNITY."

— LINDA CHATMAN THOMSEN, DIRECTOR OF THE SEC'S DIVISION OF ENFORCEMENT

problems had on Kmart's relationship with their vendors.

Peter H. Bresnan, an Associate Director in the SEC's Division of Enforcement stated, "Investors are entitled to both accurate financial data and an accurate description of the story behind the numbers. Kmart's senior management failed to honestly inform investors that Kmart faced a liquidity crisis in the third quarter of 2001, how the company's own ill-advised action had caused the problem, and what steps management took to respond to it."

This case is unusual because the SEC is alleging misleading narrative in the MD&A, not false numbers. It is important to verify the accuracy of any statements, including narratives, on all documents submitted to the SEC. ■

CHANGES TO ATM FEE NOTIFICATIONS?

On August 19, 2005, the Federal Reserve Board proposed to clarify the disclosure obligations of automated teller machine (ATM) operators with respect to fees imposed on a consumer for initiating an electronic fund transfer or balance inquiry at an ATM. The Federal Reserve's proposal would amend Regulation E and the official staff commentary to the regulation. Regulation E implements the Electronic Fund Transfer Act, which was enacted to establish the rights, liabilities, and responsibilities of participants in electronic fund transfer systems.

Regulation E provides that that an ATM operator that charges a fee for initiating an electronic fund transfer or balance inquiry must post notices at

ATMs that a fee "will" be imposed. The proposed amendments would provide that an ATM operator must only post notice that a fee "may" be imposed. The proposal clarifies that there may be circumstances, such as where a card has been issued by a foreign bank, under which some consumers would not be charged for services. Notwithstanding that the notice states that a fee "may" be imposed, a more detailed disclosure will still be required to be



The average ATM user incurs approximately \$126 in usage fees annually

made on the ATM screen or on an ATM receipt before the transaction is completed.

Financial institutions should monitor this proposed amendment, which, if adopted, may permit financial institutions to modify their disclosures regarding ATM fees. ■

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