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FOR RELEASE: 10:30 a.m. EST, April 6, 1973

THE DIRECTOR'S DILEMMA

An Address By

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April 6, 1973

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Fairmont Hotel
Dallas, Texas

It is a pleasure to be here in Dallas this morning to discuss a subject that I know is of vital importance to many of you: responsibilities of the corporate director under the antifraud provisions of the federal securities laws. Specifically, my concern involves the outside director, who does not participate in the day-to-day management decisions of the corporation, but who has both a practical and legal obligation to oversee and direct its fortunes. It is this aspect of corporate responsibility that I would like to focus on today.

It should not be surprising that we at the Commission have been reading that many people today are afraid to serve as directors of various corporations because of the rather extensive liability some courts, with the assistance of 20-20 hindsight, have been asserting directors must bear.

To be sure, we are living in an era of litigation. Corporations, their executives and directors increasingly have become the targets of suits by shareholders and others. The April issue of Fortune magazine, in an article entitled "The Legal Explosion Has Left Business Shell-Shocked", reports that the annual bill for legal departments and outside counsel for American companies may well amount to something in the neighborhood of $3 billion. The companies surveyed by that magazine reported that their legal expenses have grown an aggregate of 60 percent over the last six years. It would seem that law is a real growth industry; perhaps the law firms should incorporate themselves rather than their clients, and let everyone share in the litigation boom. In this vein, I know that many of you do not have the opportunity to peruse, in those rare moments of leisure, the legislative history of the Securities Exchange Act of 1934. But of all the statements made in Congress at that time, one seems particularly appropriate here. In complaining about the complexity of the bill which ultimately became the Securities Exchange Act, a cynical or perhaps realistic Congressman suggested that one class of persons would surely benefit from all of the bill's intricacies. He noted that:

> "Its provisions are unclear, so much so that members of the committee who have been sitting for weeks working over this bill line by line are not agreed as to precisely what it means. One thing is certain, if this measure is enacted, following upon many others with perplexing obscurities, there is one profession at least which will not suffer from unemployment, and that is the profession of the lawyer."

While, as a lawyer, I am, of course, sympathetic to anything which generates business for lawyers, I must confess that at the Commission we have been working on a different approach. This is a regulatory approach by which the Commission, through the issuance of position papers interpreting its own rules, seeks to define more clearly the responsibilities of those in the corporations. Part of the problem is that the progress of case law, in as sensitive an area as fraud, has not been entirely to our satisfaction. The really basic issues simply have not found their way into decided cases, and the so-called "big" cases usually manage to underestimate certain pragmatic, nonlegal problems faced by industry -- problems that are easy to ignore in the face of the truly egregious facts those cases usually present. There is just no getting around the fact that hard cases can, and often do, make hard law. I think it is unfortunate that there is confusion and concern of a magnitude that can deprive some companies of the talent, the expertise and the independent view that outside directors can bring.

The Commission feels a sense of obligation to the courts, to public investors, to the securities bar and to those persons whose activities may place them within the structures of the federal securities laws, to enunciate the broad standards these Acts impose. I believe the players have a right to know what the rules of the game are.

For these reasons, I should like to outline some of the concerns we have about the responsibilities of directors under the antifraud provisions of the federal securities laws. Now, I recognize that my topic is a rather ambitious one, and before any of you set your sights too high or prepare to take copious notes, I want to warn you that I am not going to present to you definitive answers to the day-to-day problems with which you are

concerned. I doubt whether such answers even exist. Rather, I hope to outline some broad policy positions and raise some specific problems with which directors must deal, so that the corporate community is at least on notice of the issues which cry out for resolution.

We hope that some of these issues will be further clarified and delineated in a comprehensive position paper on the responsibilities of directors, now in preparation at the Commission. We are hopeful that we can release this position paper, for public comment, within the next four to six weeks. In the meantime, I should like to share with you some of my present thinking.

1. Types of Directors

Any discussion of the responsibilities of corporate directors must start out, naturally, with some definition of the term "director". The era when each of the directors of a company also engaged in its management has long since passed, if it ever existed. This is the age of specialization in all fields. The management of corporations is no exception.

Certainly, there are those directors who are engaged in the day-to-day management and running of their companies. Most often, these directors hold positions as officers of the company and are appropriately called "inside" directors. As managers of their companies, inside directors have far greater access to corporate information and are more intimately involved with the establishment of corporate policies than any other employees, officers or managers of the company. Also, by virtue of their control over corporate information, these directors determine to some degree both the ease and the extent to which other directors are able to get the details on critical corporate activities. Because of their involvement with daily corporate management, inside directors should -- and do -- bear the heaviest burdens of liability under the federal securities laws.

The liability of other directors under the federal securities laws, however, is less clear. These directors do not participate in the day-to-day management decisions of the

companies on whose boards they sit. While this group can be given the broad general label of "outside" directors, these are two important facts to remember: first, outside directors are nonetheless directors, with important responsibilities and obligations; second, there are several categories of outside directors, each with distinct and different roles to play.

One type of outside director, whose numbers have been expanding rapidly, with the strong and persistent cry for greater corporate social responsibility, is the public interest representative. I believe the idea of public interest representatives on corporate boards is a sound one; I am encouraged by the growth of this practice. Public interest directors have a broad responsibility to public investors and to shareholders. But the fact that these directors usually come to their positions with little technical expertise makes clear that the automatic imposition of broad liability upon all persons bearing the title of director certainly is not in the public interest.

There are other categories of outside directors as well. As I am sure you are aware, the boards of innumerable companies are comprised of directors who are appointed or elected for a variety of factors -- their prestige and proven judgment, their ability to bring a fresh, independent view to corporate boardrooms or their expertise in some field.

Unfortunately, there are some outside directors who sit on corporate boards mainly to protect the private interests of others. Directors who serve under these circumstances leave themselves open to charges of conflict of interest which may be actionable under the federal securities laws in certain situations. And the courts also have carved out particularly detailed responsibilities for lawyers and other sophisticated business men, such as investment bankers, who sit on corporate boards. Whether they properly are called "inside" or "outside" directors, these directors should be aware that they may be held to the highest standards of conduct.

2. Responsibilities All Directors Share

There are crucial responsibilities which must be borne by all directors.

First, directors are fiduciaries and have an affirmative responsibility to act fairly and honestly to seek to assure that their corporations do the same. They owe this responsibility not only to their own shareholders but to all public investors who buy, sell or hold their company's securities. I think this needs little elaboration.

Second, directors are under a continuing obligation actually to carry out any special duties for which they have volunteered or been designated. I think this responsibility is particularly important so that the investing public is not given a misleading impression that a director is actively protecting their interests in some vital area, when in fact he is hardly active at all. Today, for example, there is a growing use of auditing committees by corporate boards, made up of non-officer directors, who meet with the corporate auditors in the absence of the officers of the company to get an independent picture of the corporation's financials. The Commission has encouraged the formation and utilization of these committees to provide an independent check on the corporate officers. If an outside director fails to fulfill his functions on this committee, however, I believe he should be held accountable for any corporate misdeeds he might reasonably have been expected to uncover if he had faithfully performed his assigned tasks.

Third, all corporate directors bear on absolute responsibility not to participate in a fraud, or to aid or abet a fraud, in which the corporation or some of its personnel are involved.

As a fourth basic responsibility, I believe the federal securities laws require that all directors avoid negligence in the performance of their responsibilities. Now, I recognize that negligence is a vague enough term which has filled the casebooks with thousands of decisions. But perhaps I can focus a bit more precisely on this. Essentially, a director is negligent if he knows, or should have known, of actions or potential actions that could violate the securities laws. The concern here is with the conduct and not

whether it actually is known to be a violation of the law. The courts do not require proof that an accused director knew the precise scope of the law. What is required to be shown is that the director knew, or should have known, of conduct which later is held to be a violation of the federal securities laws.

Fifth, all directors have a duty to act on wrongdoing of which they are, or should be, aware -- even when they do not carry responsibility for that particular area. As holders of a public trust, directors who learn of any fraudulent conduct must insure that appropriate steps are taken to prevent or rectify violations. This is particularly crucial in the securities field, where most violations and their impacts are long enduring. The knowledge or indication of fraudulent corporate actions puts a clear obligation on all directors to insure that corrective action is taken.

The essential first steps in these cases is for the director to try to get appropriate corrective corporate action -- either by advising the board of directors of his information or, if that fails, by bringing the matter to the corporate counsel. Should the board of directors prove unwilling to act, the director's responsibility does not end. If the company's securities are listed on an exchange, the director could apprise that exchange of the violations so that trading can be suspended pending information on the situation. The director also should consider coming to the Commission with whatever information he possesses.

I do not expect there is much disagreement with my suggestion that when any director knows of the misconduct, his obligation to act is triggered. The real sticking point, I suppose, is the determination of when a director "should have known" of misconduct. That determination, I believe, must depend upon the particular functions assigned to or assumed by the director, the reasonable expectations of public investors, and other specific circumstances. I cannot hope in this speech to delineate these specific situations. Our position paper, however, will provide some detailed treatment of this problem.

3. Some Suggestions for Outside Directors

There is a marked tendency today for some courts to gloss over the fact that outside directors of companies often are effectively blocked by inside directors from getting vital information to make informed judgments on corporate affairs. This is why inside directors should, in my views, bear the greatest responsibility under the federal securities laws.

Part of this problem can be cured, however, if outside directors attend corporate meetings with sufficient regularity, or if they are unable to attend, apprise themselves of important corporate occurrences by other means. I recognize that attendance at board meetings does not automatically make a director fully informed. It is obvious that a corporate meeting, with the recording secretary furiously taking notes, is the last place where the details of a fraudulent scheme would unfold. But outside directors cannot avoid the imposition of liability simply by asserting that they were not made aware of necessary, relevant corporate information. They have a continuing duty to seek out and receive this information. Outside directors may not be charged with responsibility for the day-to-day management decisions of their corporations, as are inside directors, but they assuredly are charged with the general management of these enterprises.

When outside directors are asked to vote on critical issues, they should be able to determine whether they have enough information upon which to base an intelligent and informed vote. I do not think the federal securities laws will tolerate outside directors meeting anything less than this burden, completely and fully. Outside directors who choose to gamble by approving action without a sufficient basis for doing so may find the cost to be very high. As in all areas of professional responsibility, a great deal of trust must be placed in the integrity and conscientiousness of all those people who assume the position of corporate directors. And the existence of civil liability is a deterrent to a cavalier disregard of these obligations.

There are circumstances where it should be perfectly clear to an outside director that he does not have sufficient information to approve proposed corporate action or to ratify management decisions. For example, in many instances, registration statements, proxy statements or other periodic reports required to be filed with this Commission under the federal securities laws are shoved under the noses of outside directors, for signature or approval. Certainly, if the director does not read the document before he signs it, authorizes it to be filed or approves it, not even Perry Mason, or, since we are in Dallas, Judd for the Defense, will be able to avoid the inevitable imposition of civil liability for such recklessness. Outside directors should resist all attempts to pressure them into approving complex decisions in the absence of adequate time for preparation and full understanding. This includes insisting on ample time to digest and understand vital documents. I recognize that it would be far easier if outside directors could rely upon other members of the board of directors or corporate employees to read and summarize these materials for them, but I believe that a director's basic responsibility requires that he read these materials. Although directors cannot delegate their responsibility to direct, I do believe they should have access to reliable experts who can help them decipher some of the highly technical jargon contained in corporate releases and filings.

Corporate press releases also pose problems. Where a director is asked to approve a corporate press release, he is, in my opinion, under a duty to assure himself that the release has been carefully and diligently prepared. Certainly, if he is alert to the possibility that the release contains misleading statements, or subsequently discovers this fact, even if the original release was not approved by him, he is under an obligation to take necessary steps to insure that the investing public has not been misinformed or that any existing misinformation is corrected.

Finally, I believe that outside directors have a responsibility to read and examine the annual reports disseminated to their shareholders. These reports are the most basic

communications between the corporation and the investing public. It is important that directors satisfy themselves that the document truly reflects the condition of the corporation and that the representations it contains are consistent with the facts. This is particularly true of the president's message, which should set a tone of forthrightness and credibility, and not gloss over real problems.

Corporate enterprise owes a great deal to the outside director. His counsel, his independent view, his expertise, his social interest all trigger new ideas and approaches without which corporations and their enterprises cannot flourish. It is my hope that the Commission's position paper will bring greater certainly and clarity to the question of the responsibilities of the outside director so at a minimum he will know what his obligations are.