NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

A COMMISSION DILEMMA: DIRECTORS' GUIDELINES REVISITED

An Address By

Ray Garrett, Jr., Chairman

Securities and Exchange Commission

May 7, 1974

THE CONFERENCE BOARD

The Fairmont Hotel
San Francisco, California

A little over a year ago my predecessor as Chairman of the Securities and Fxchange Commission announced that the Commission would prepare and publish guidelines with respect to the responsibilities and liabilities of corporate directors under the antifraud provisions of the Federal securities laws. The Commission had brought some legal actions and was known to be contemplating more which had led to complaints not just of harshness but of bewilderment. Surprise was expressed at some of the Commission's legal positions and so was a feeling of alarm at what we might come up with next. Guidelines would assist directors and their counsel in knowing what was expected of them, at least in our judgment.

Many months ago, when I accepted the invitation to speak today, I had hoped to be able, proudly, to announce that we had completed our work on the project and to outline for you the Commission's definitive position on this thorny subject. Unfortunately, I cannot do this. Our work on guidelines has not been completed and cannot fairly be described as even close to completion.

In addition to the matter of priorities, delay is the product of differences of opinions within our ranks. These differences have been made manifest in our prolonged debates over complaints that the staff has proposed filing and that we have been asked to authorize. Difficult as these proposals have been to resolve, it is somewhat easier to reach agreement upon a concrete proposition based on specific facts, or alleged facts, than it is upon generalized statements of principles, unless they are so generalized as to be meaningless.

A brief digression may be helpful to those of you who are not securities lawyers and have not become familiar with the jurisdictional basis for our concern. Section 11 of the Securities Act of 1933 sets forth specific provisions governing the liabilities of directors, and others, of companies that sell securities to the public by means of a registration statement under that act. This is the section that Judge McLean was concerned with in the famous BarChris[1/] case a few years ago. But this is not the section of interest to us today. Our concern focuses primarily on Rule 10b-5 under the Securities Fxchange Act of 1934. This rule makes it unlawful to make any false or misleading statements or engage in any fraudulent conduct in connection with the purchase or sale of securities.

1/ Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y., 1968).

Whatever one may think of the quality of the jurisprudence involved in getting there, it is now well settled that the application of the rule does not require that the company itself buy or sell any securities. It is enough that someone is buying and selling, and there is argument on whether even this much should be required. The result is that if a company releases false and misleading information, including financial statements, and there is trading in its securities, the company has violated Rule 10b-5. The company's directors may be reached personally, either on the theory that they were active participants in the fraud or that they aided and abetted its commission. In any given case, the lawyers can usually make it seem a good deal more complicated, but this is the essential proposition. Turning it around, the question becomes what action or inaction should cause directors to be held personally liable for a violation of the rule or for aiding and abetting its violation? Inasmuch as almost any corporate misconduct not fully and immediately disclosed to the public can be brought under the rule, this proposition cuts much wider than would at first appear, and it gets us into the fundamental question of the duties of a director. We would readily agree that a director who has fully performed all of the duties the law requires of him should not be personally liable even though his company has violated Rule 10b-5 or any other provision of the Federal securities laws. Fven we do not propose to make him a guarantor.

Our legal remedies may also seem curious to many of you. If we believe that a director should be liable for a Rule 10b-5 or other violation of our laws, we have no statutory authority to sue him for money damages or to prosecute him for a crime. If we think the facts justify criminal prosecution, we refer the matter to the Department of Justice, which may or may not agree with us. Otherwise, our recourse in the civil courts is to seek an injunction against further violations of the law. In our petition for an injunction we may add pleas for what lawyers call ancillary relief -- removal from the board, perhaps the appointment of a receiver, repayment of unjust gains. Our intention in all cases is law enforcement. Except incidentally to that objective, we do not serve as a collection agency. As a matter of fact, the filing of an injunctive action by us normally alerts the securityholders and their lawyers, and one or more of them may bring private actions based on the facts that we have developed.

Let me discuss with you some of the troublesome questions before us, and briefly summarize the direction in which I would like to see the project go. I am well aware that, in recent years, there have been widely-expressed apprehensions that so-called "outside directors" of publicly-held corporations face intolerable risks of civil liability in actions arising under the federal securities laws, particularly the general antifraud provisions of those laws. And concern also has been expressed that outside directors are being held to standards of conduct which are unreasonably high, particularly in light of the practical limitations on their abilities to learn of, or to prevent, conduct by their corporations, by their fellow directors, or by corporate officers and employees, which would give rise to a cause of action.

One of the most difficult problems we face is this conflict between what most outside directors actually do, and what, in the interest of better investor protection, they should be doing. As a practical matter, the outside directors of most large publicly-held corporations in the United States today generally cannot be expected to, and, in fact, do not, devote sufficient time and attention to corporate affairs to obtain a thorough familiarity with the details of all major corporate activities, much less the day-to-day business operations of the corporations on whose boards they serve.

Most outside directors hold full-time jobs elsewhere, frequently as senior executives of other large companies, or as members of law, accounting, or investment banking firms; others may hold responsible positions in the academic community. And many outside directors serve on the boards of several corporations. Such persons generally are selected to serve on boards because it is believed that their experience and demonstrated competence in another business or in a professional field enables them to add much needed objectivity, perspective, and judgment to corporate decision making, which cannot be provided either by full-time employees of the corporation or by consultants and experts which could be hired by management; or, sometimes even now, I suspect, they are selected because their popular esteem will decorate the board or because they offer helpful business connections.

Of course, individuals actively engaged in other businesses or professions cannot devote full time to their duties as directors, and probably should not be expected to do so. Indeed, a recent study 2/ by Lamalie Associates, based on a group of companies selected from Fortune's list of 500 largest industrials, indicates, that, on the average -- and their average includes inside and outside directors -- directors devote only about eleven hours per month to the performance of their functions as directors. Some other interesting statistics were gathered by Korn/Ferry International, in their Board of Directors Annual Study of 327 of America's largest companies this past September. 3/ That study revealed that most companies hold less than twelve board meetings per year, and most pay board members less than $7,000 per year as an annual fee, and between $100 and $250 as a per meeting fee. Both studies indicate that the vast majority of companies do not give their directors stock or other forms of non-cash compensation.

2/ Lamalie Associates, Inc, Trends in Corporate Direction, 6-7 (1972).

3/ Inside Today's Boardroom, 2 AMR Current Developments for the Corporate Director, 6-10 (Feb., 1974).

Another sobering view comes from Professor Myles Mace's study, entitled Directors: Myth and Reality.[4/] Professor Mace took a look at what directors actually do and, more important for our purposes, what they do not do. Among other things, Professor Mace concluded that in many cases they do not establish corporate objectives, corporate policies or corporate strategies, nor do they select the president of the corporation, and they do not even ask discerning questions at board meetings -- principally because of the lack of time.

In view of these data, and in light of the size and complexity of most modern U.S. corporations, it seems unrealistic to take the position that outside directors have an obligation to keep themselves thoroughly informed of all aspects of a corporation's affairs which may come within the purview of the federal securities laws, much less to suggest that an outside director has an obligation to inquire into, or to investigate, the details of every corporate transaction in order to assure that no violations of the securities laws have occurred or are about to occur.

4/ M. Mace, Directors: Myth and Reality (1971).

On the other hand, I believe that adequate investor protection requires that persons who accept positions as corporate directors assume most serious responsibilities, which cannot be ignored, notwithstanding any other obligations they may have or limitations on the time they have available to devote to corporate affairs.

It would be easy to say that outside directors have an obligation to seek, and to make sure that they obtain, whatever timely, sufficient and accurate information is necessary to enable them to exercise informed judgment with respect to corporate affairs and to direct the corporation and its management in a careful and conscientious manner. But it is not so easy to define what that means, or to suggest how such a feat may be accomplished. For, unless corporations depart from the present practice of seeking highly experienced individuals, most of whom are active in other jobs, to serve as outside directors, it seems most unlikely that outside directors will increase significantly the amount of time they spend on the job, regardless of the threat of civil liabilities they may face. Most outside directors will continue to be very busy people with only nominal amounts of time to give as directors.

Perhaps we should take a radical approach to the problem and suggest that outside directors, who by their very nature are able to spend very little time performing their duties as directors, are essentially worthless and should be abolished. But it is generally agreed that part-time outside directors can, and do, make a valuable contribution to the corporations on whose boards they serve, notwithstanding the limited time they are able to devote to the task. As early as 1933 -- a period of great corporate reforms -- then professor, and now Mr. Justice, Douglas, writing about the Securities Act of 1933, stated that

> ". . . though there may be some or many directors who do not 'direct' (in the sense that they merely draw prestige and fees from the position) there are a great many, particularly of the larger and more complicated enterprises, who do and yet are not personally familiar with all details of operation. Nor could their services be obtained in most cases if they were required to investigate details of the enterprise. The experience and judgment of men of affairs is of great value to most of our more important corporations. To deprive enterprises of this asset would seem uneconomic in view of the slight gains which may be expected." 5/

And the New York Stock Exchange noted in its recent White Paper on Financial Reporting to Shareholders and Related Matters that

> "The election of 'outside' directors to the boards of publicly owned companies has become a widely accepted practice. Outside directors can add perspective and objectivity to corporate decision-making. In many cases, they function effectively as representatives

---

5/ Douglas and Bates, The Federal Securities Act of 1933, 43 Yale L. J. 171, 195 (1933) (footnotes omitted).

> of both the public interest and shareholders, and make substantial contributions to improving corporate credibility. They can be especially helpful in guiding and monitoring the company's timely and adequate disclosure practices."
>
> * * *
>
> "The benefits of having outside representation on the board are both well-documented and widely acknowledged. Therefore, the Exchange recommends that a minimum of three outside directors be included on the board of each listed company." 6/

The Listing Policies of the New York Stock Exchange suggest that at least two outside directors be included on the board of each newly-listed company.

Even the Commission, in the not too distant past, indicated that it believes it is in the public interest, and the interest of investors, to encourage the election of outside directors to the boards of publicly-held companies, by endorsing the establishment of audit committees composed of outside directors.

Possibly, we should endorse one or more of the suggestions recently made by proponents of reform in the boardroom and intended to enhance the abilities of outside directors adequately

---

6/ The New York Stock Exchange, Inc., Recommendations and Comments on Financial Reporting to Shareholders and Related Matters: A White Paper, 5-6 [December, 1973].

to meet their responsibilities, such as the use of full-time, full-salaried outside directors, the establishment of an independent staff for outside directors, or the adoption of the German system of a two-tiered board. We have not done so.

We have, rather, struggled with the question of the standards of care which should be applied in determining an outside director's liability with respect to corporate activities which are subject to the federal securities laws. Standards of a director's responsibilities in the ordinary management of a corporation's affairs are governed by state statute and common law, and those standards generally are low and hazy. Of course, where corporate activities are subject to the federal securities laws, a director's responsibility and liability with respect to those activities properly should be measured by standards established by federal law. But what should those standards be? Is mere negligence sufficient to establish liability, or should proof of some form of knowledge or scienter, or its equivalent, such as recklessness or a willful disregard for the truth, be required?

And should we urge one standard on the courts in private litigation and follow a different standard in our own enforcement actions, where generally the courts have held that negligence alone is sufficient to support a finding of violations and the issuance of an injunction? It may be reasonable for us to get an injunction against continued negligence by directors of a publicly-held company and yet require something more, an actual or constructive dirty mind, for personal liability.

In our brief, as amicus curiae, in the Lanza v. Drexel 7/ case, we argued a sort of middle ground, that an outside director should not be held liable to a third party unless he knew, or had reasonable cause to believe, that unlawful activity was taking place. The awareness of some fact that suggests that something may be wrong arguably creates the duty to inquire further, but in the absence of such awareness there is no such duty.

Perhaps we should abandon the scienter test altogether, and follow a more flexible approach, such as that suggested by the United States Court of Appeals for the Ninth Circuit in its recent opinion in White v. Abrams. 8/ There, the court rejected the use of one standard for state of mind in all 10b-5 cases as confusing and unworkable, and indicated that the proper standard is the extent of the duty that Rule 10b-5 imposes on a particular defendant. In determining the duty owed by a particular

---

7/ Lanza v. Drexel, 479 F. 2d 1277 (C.A. 2, 1973) (en banc).

8/ White v. Abrams, [Current] CCH Fed. Sec. L. Rep. ¶94,457, at 95,603 (C.A. 9, 1974).

person in a particular case, the court suggested that a number of factors "found to be significant in securities transactions" be considered, with state of mind or scienter one of the facts to be considered, but not a necessary and separate element of a fraud action.

Another problem we have encountered is the question whether different standards of care should be applied to inside directors, those who are also active officers and employees of the corporation, than to outside directors, or whether it would make more sense to consider the individual circumstances and characteristics of each director, whether inside or outside, in determining the duty of care owed and whether liability should be imposed for breach of that duty. Should we for example, consider as relevant such factors as a director's educational background, training, and experience, or his length of service on the board, relationship to management, and other factors reflecting on his ability to comprehend, or obtain access to, information about the corporation and the transaction in question?

For example, should an outside director, who is an expert in a particular field, such as accounting, be held to a higher standard of care with respect to a corporation's accounting practices, and incur liability for failing to discover problems in that area, when another outside director, who is not an expert in accounting, would not be held liable? And should there be differences in standards of care based on any special responsibilities assumed by a director, such as membership on an audit committee?

Or, should the expectations of shareholders with respect to the services to be provided, or functions assumed by a particular director also make a difference? We see problems, for example, with respect to "special interest directors," those who may be elected as representatives of a minority group or conservationists or consumers. Should they be subject to the same responsibilities and liabilities as other directors who are sophisticated businessmen of long experience? As a practical matter, perhaps the answer should be no. On the other hand, is it feasible or desirable to make such distinctions as a matter of law? Would full disclosure to shareholders and investors of the nature and purpose of a special interest director's role suffice to alleviate liability?

We also have puzzled over the question whether a director's duty of care should vary according to the nature and significance of the transaction involved -- that is, should a higher standard of care be required with respect to major transactions, such as mergers and acquisitions, than with respect to more routine matters, such as the issuance of press releases or quarterly financial reports, even though a fraud committed in connection with a relatively routine matter could have as great, or a greater, impact on the securities markets? Would it be naive to suggest that directors be particularly sensitive to, and be held to higher standards of care with respect to, transactions involving the sale of securities or affecting the securities markets in an issuer's stock, to assure that violations of the securities laws are not taking place? There may be other, more significant, areas of a corporation's affairs which a director should be attending to, such as business practices which may violate the antitrust laws, and subject the corporation to treble damage liability in the hundreds of millions of dollars, or problems of plant and product safety, which could adversely affect the lives of many innocent people, not just their pocketbooks.

And, even assuming that we settle all of the foregoing questions, and others, and set forth appropriate standards of care for outside directors and sound theories for their legal liabilities, what should we expect of a director who suspects or even discovers that his corporation, its officers or employees, or his fellow directors are engaged in unlawful activities? He should, of course, take steps to prevent, or put a stop to, any unlawful activity. But what should those steps be? And when should liability attach for his failure to act?

Clearly, he should advise the full board and management of his concerns and possibly discuss the matter with the corporation's outside counsel or independent auditors. And, if no action is taken by the board, by management, by the auditors or by counsel to resolve the problem, and if it involves a matter submitted to the board for its approval, he should vote against the transaction and note his dissent in the corporate minutes. If he deems the matter serious enough, he could resign. But should he do more? Should he bring the matter to the attention of the appropriate regulatory authorities, or law enforcement officials, if any? And what if he is unable to confirm that there is merit to his concerns? Should we suggest that he make public his suspicions or beliefs, to the press, to shareholders, or to the other party to a transaction? To so require might place a director in the untenable position of having to choose between risking a lawsuit against him by the corporation for slander or something worse if he were wrong, or risking liability in an action brought under the securities laws by a third party or the SEC if he turned out to be right, and had done nothing.

Finally, we have the basic question of what form our position paper should take -- should we attempt to provide some specific guidelines to outside directors which are designed, as much as possible, to provide a protective umbrella from civil damage suits in the hope, of course, that the courts and private litigants will follow our advice? Should we simply issue a law review-type discussion of the existing state of the law, with a view to alleviating some of the uncertainty in this area, and let the law continue to evolve on a case by case basis? Or should we take a hard line and assert that outside directors indeed have serious responsibilities and face grave risks of being held liable in civil actions for failing to live up to those responsibilities in the hopes that "do-nothing" directors will tremble in fear and disappear from the boardroom.

Whatever we may do, we must take care not to restrict unduly our ability, at a later date, to take enforcement action in a case where we believe the facts and circumstances to be particularly egregious. In short, our guidelines must not be a convenient road map for fraud.

I sincerely wish I had the answers to these questions.

At present, however, I am inclined to the view that an outside director, who does not directly participate either in his individual or official capacity, in violations of the antifraud provisions of the federal securities laws, except perhaps by voting to approve a particular transaction, should not be held liable for those violations unless he knew or had reasonable cause to believe that the unlawful activity was occurring or was about to occur and, in addition, failed to take adequate steps to prevent it. Absent such actual or constructive knowledge, where an outside director has been conscientious and diligent in discharging his duties, has made reasonable efforts to keep well-informed with respect to the affairs of the corporation on whose board he serves, and has relied in good faith on information provided to him or representations made to him by officers or employees of his corporation, I do not believe he should be subject to liability solely by reason of his having authorized or approved a given transaction or solely by reason of his position as a director of the corporation.

Whether an outside director participated in, or had actual knowledge of, unlawful activities is, of course, a question of fact, and one which rarely has come up in civil litigation. More likely to arise, and more difficult to determine, however, is the question when, and under what circumstances, an outside director should be held to have had constructive knowledge of unlawful activities, that is, reasonable cause to believe, under the circumstances, that the corporation, its officers or employees, of his fellow directors were violating or were about to violate the law. Equally difficult of resolution is the question what type of action, if any, an outside director can reasonably be expected to take to prevent unlawful activity which he knows or has reasonable cause to believe is taking place. And both questions can be definitively resolved only in the light of all the facts and circumstances of each particular case.

I also believe that where an outside director has been conscientious in performing his duties, diligent in his efforts to keep well informed about the corporation, and an active participant in corporate affairs, he should have no independent obligation to investigate the details of each and every corporate transaction in order to assure that no violations of the securities law have occurred or are about to occur -- except, of course, where there is a specific statutory requirement that he do so, such as under Section 11 of the Securities Act of 1933. To suggest that such an inquiry or investigation be made in connection with all corporate activities which come within the purview of the federal securities laws, would clearly be unreasonable, particularly in light of the size and complexity of most modern U.S. corporations, and the relatively limited amount of time that even the conscientious outside director is able to spend on the job.

An outside director who has been reasonably diligent in discharging his duties and responsibilities should be entitled to rely on the fact that information triggering a duty of further inquiry or corrective action on his part will come to his attention in the normal course, unless, of course, information has been deliberately concealed from him by management or others. Under these circumstances, and absent proof that he received information which would prompt a reasonable man in his position to make a further inquiry into the facts, an outside director's failure to discover unlawful activity should not be characterized as a breach of duty.

But, where an outside director obtains information or observes circumstances which would give a reasonable man in his position grounds to suspect, or to believe, that information provided, or representations made, to him by the corporation's officers or employees or his fellow directors, may be inaccurate, incomplete, or misleading, then I believe he no longer should be entitled to rely on the representations of others, and has a duty to inquire further to endeavor to determine whether any unlawful activity is going on. If, after receiving notice of suspicious facts and circumstances, he makes no further inquiry, then I believe that it is reasonable that he be held to have had constructive knowledge of whatever facts he could have obtained by such further inquiry.

Similarly, in cases where an outside director has not conscientiously performed his duties as director and has failed to make good faith efforts to keep himself adequately informed with respect to corporate affairs, and thereby has avoided placing himself in a position where he would receive actual notice of unlawful activities, or even notice of facts and circumstances requiring further inquiry on his part, except by sheer accident, then I believe it is appropriate that he be held legally responsible for any unlawful activities which he would have known, or reasonably could have discovered, were it not for his failure to perform his responsibilities and obligations as a director.

In determining whether a director has been diligent and conscientious in performing his responsibilities, I think it important to look at such factors as whether he regularly attended board meetings, whether he sought and obtained information from management with respect to important corporate transactions, and carefully considered the information he received, whether he was an active participant in board meetings and raised questions with the management, as well, of course, as the time he spent in discharging his duties. In addition, I think it is important that the board as a whole be responsible for assuring that the corporation has adequate procedures to provide for the regular flow of timely, accurate and complete information to it from the management with respect to significant transactions and special problems. Such procedures, of course, should provide that directors have access to any written material concerning matters to be considered by the board sufficiently in advance of a meeting to enable the directors to read and consider it.

I cannot, of course, guarantee that these general views of mine will necessarily prevail in Commission deliberations either on the guidelines or in authorizing particular lawsuits. All I can promise is that we will strive to bring as much order and good sense into this area as we can, consistent with our conception of our duty to seek the highest practicable degree of protection of investors' interests in corporate management. We do not want to make the game so hazardous that no one will play. On the other hand, you must recognize that some highly regarded companies have produced some shocking examples of mismanagement and disregard for the welfare of investors whose savings had been put into their securities.

It might be simplest to say that we want a state of law that will generate no despondency in the hearts of those many boards of American companies that adhere to high and satisfactory standards, and have for years, without waiting for the government to scare them into it, and that at the same time will provide the appropriate emotional stimulus to cause all others to do likewise.