DIRECTORS' RESPONSIBILITIES
IN THE UNITED STATES

Speech to be Delivered By
Arthur H. Dean
On December 5, 1966
at
The Canadian Club
Toronto, Canada

I am indeed delighted to be here and to have the opportunity to discuss with you some of the responsibilities of directors of publicly held corporations.

As one who participated in the drafting of the Securities Act of 1933, the Trust Indenture Act of 1939 and the Investment Company Act of 1940 and as a member of the Dickinson Committee which in its report recommended to Congress the creation of the Securities and Exchange Commission and the enactment of the Securities Exchange Act of 1934, I have long been an advocate of adequate public disclosure of material corporate matters.

The 1933 Act relates primarily to the public sale of securities by issuers or controlling persons. The 1934 Act relates to purchases as well as to sales of securities, and applies to outstanding securities as well as to newly-issued or "control" securities, whether or not listed on a national securities exchange.

I will discuss later in more detail the differences between the two Acts.

The late Mr. Justice Cardozo certainly was one of the most articulate spokesmen in the area of fiduciary responsibility. In Meinhard v. Salmon,[1] when he was Chief Judge of the Court of Appeals of New York, he said:

> "Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than trodden by the crowd. It will not consciously be lowered by any judgment of this court." (At 249 N.Y. 463-64)

I have read with interest the recent report of the Ontario Attorney General's Committee on Securities Legislation, dated March 11, 1965 which you call the Kimber Report.

I have noted particularly the recommendations there with respect to possible Ontario legislation imposing director liability in the event of trading on the basis of inside confidential information.

The Kimber Report rejects absolute liability for short-swing profits such as that imposed by Section 16 of our Securities Exchange Act of 1934.

---

1. 249 N.Y. 458, 164 N.E. 545 (1928).

Two objections are raised: First, that "liability should only arise if wrong-doing or impropriety is established and not on an automatic basis," and that it is "unseemly" for these suits to be instituted by private lawyers -- as distinguished from lawyers for the corporation itself -- "for the purpose of obtaining legal fees."

The Kimber Report recommends increased requirements for financial reporting, and for the content of prospectuses and proxy solicitation material.

The Kimber Report cites Percival v. Wright,[2] as limited by Allen v. Hyatt,[3] as establishing only a very limited doctrine in England and Canada of director fiduciary responsibility in dealings between a director and stockholders.

Unless the director deals in company securities with a stockholder virtually face to face, there is probably no breach of fiduciary duty in England and Canada for failing to disclose confidential information.

Indeed the majority common law rule in the United States, illustrated by Goodwin v. Agassiz,[4] is probably the same.

Because of uncertain and unsatisfactory state of the law under these cases, the Kimber Report recommends that the problem be handled by legislation in Ontario as it has been in the United States.

---

2. [1902] 2 Ch. 421.
3. 17 D.L.R. 7(1914).
4. 283 Mass. 358, 186 N.E. 659 (1933).

In Canada, the Government of the Province of Ontario seems to be the place where developments in securities laws and regulation are being pursued to the greatest extent. In the United States, other than State blue sky or anti-fraud laws or decisions on state corporation laws, it is the Federal government which has been the leader in studying the problems of corporate disclosure and developing the ground rules for disclosure in connection with the issuance or sale of securities in interstate or foreign commerce.

This may be due to historical and Constitutional differences between our two countries in the regulation of the securities industry, but not to the nature of the corporation itself. The United States has no Federal incorporation act as such.

Publicly-held corporations in the United States, with limited exceptions which are disappearing, have both inside or "management" directors as they are often called, and outside or non-management directors, with the outside directors constituting, for more and more corporations, a majority of the board.

Inside officer-directors are obviously better informed on day-to-day management of a business as part of their daily duties, and can be said to be directors who "direct". But should 'management" directors constitute the whole Board?

I believe the trend toward outside directors is

healthy, since they have the opportunity to provide a broader perspective with outside experience and generally are in a better position, or at least in a more objective position, to pass upon the compensation arrangements of officers than where the board is composed entirely of officers or employees and complete reliance must be placed on stockholders to raise questions as to corporate management.

In this sense, the term "insider", is not used synonymously with the use of that term in the cases under Sections 10(b) and 16 of the Securities Exchange Act of 1934, where "insider" refers to all directors, all officers whether or not they are directors, and in some cases probably certain non-officer employees who have access to confidential information.

The basic responsibilities of directors of a publicly-held corporation, whether in the United States, Canada or England, is to determine corporate objectives and policies, select management, determine management compensation, review management's performance, make a determination as to depreciation, write off of assets, reserves, dividends and growth, and make pertinent information available to stockholders.

It is the board which must change management when a change is called for, and it is the board which must decide whether officers are underpaid or overpaid or should have pensions, profit sharing or options. But the board itself, if there are outside directors, cannot manage in a true operating sense. Stockholder approval, preceded by full

disclosure, should be obtained wherever possible for all pension, profit sharing and option plans in which officers have an interest.

With competent, objective outside directors, it has been my experience that there have been fewer problems of public disclosure, particularly with respect to dividend, depreciation and depletion policies and the compensation arrangements of the principal executives.

The board, of course, has legal responsibility, which is often referred to as "fiduciary", to the corporation, to the stockholders and according to the SEC to members of the public about to become stockholders. To say that directors have fiduciary responsibility, however, does not say much. For they are true fiduciaries in a far different sense than trustees, who cannot have any dealings with their trusts, or of agents, and analogies to the legal principles developed in these other fields usually do not lend themselves to correct director analysis.

---

and: I suggest you omit part or all of pp. 7-15 to compress speech to 30 minutes.

Chief Justice Harlan Fiske Stone, with whom I worked when he was a member of Sullivan & Cromwell, rendered a frequently cited dissenting opinion in a U.S. Supreme Court case involving director responsibility in respect of the employee stock purchase plan of American Tobacco Company, Rogers v. Guaranty Trust Co. of New York.[5]

Speaking at the 1934 dedication of the Michigan Law Quadrangle, just after enactment of the Securities Act of 1933 and before enactment of the Securities Exchange Act of 1934, Chief Justice Stone summarized his views as follows:

> "I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.' More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition.. No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that principle.. The separation of ownership from management, the development of the corporate structure so as to vest in small groups control over the resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function."

Thus, in Turner v. American Metal Co., [6] a New York Appellate Division case, in which together with other

---

5. 288 U.S. 123 (1933).
6. 268 App. Div. 239, 50 N.Y. Supp. 2d 800 (1944), appeal dismissed, 295 N.Y. 822, 66 N.E. 2d 591 (1946).

counsel, I acted as counsel for the defendant directors, the question was whether the officers and directors of American Metal had illegally taken over a corporate opportunity which belonged to American Metal itself.

The alleged opportunity was to invest in and develop the molybdenum business at Climax, Colorado, which later became Climax Molybdenum Company. American Metal originally in 1916 took a 75% interest in the prospecting syndicate and had the opportunity to take a 75% interest in the venture, but decided in 1917, at the time of our entry into World War II, to limit its participation to 7-1/2% with its officers and directors taking up the remaining 67-1/2%. This 67-1/2% was later offered in 1920 by the officer-directors to American Metal at cost, after control of the latter had passed to a new group, but it was again turned down as too risky. Little was known then about molybdenum and its potential uses, and up to that time American Metal had not been in the mining or molybdenum business.

After molybdenum first declined in importance to a point where most people thought it was worthless, and then as metallurgy advanced, began to be a valuable alloy in steel with nickel, chrome, etc., the plaintiff stockholder in 1938 took the position that the directors as fiduciaries held their Climax investments in trust for American Metal, and that their rejected offer to turn over

their stock to American Metal was not binding because, although the rejection had been the act of a majority of the stockholders, it had not been approved by all stockholders.

The Court analyzed the nature of an investment in molybdenum in 1917 and the risks which then existed. It held that the completely new molybdenum business at that time was not so much like the then business of American Metal as to be a "corporate opportunity" of American Metal, that the decision of American Metal's Board in 1917 not to take up the entire 75% available to it in a completely different business was entirely understandable in view of the risks; was an honest judgment made with full knowledge of the facts; and there was no reason why the officers and directors could not in these circumstances take up and continue the original speculation to the extent American Metal turned it down.

There are many aspects of this case which I won't have time to cover this noon, but I cite it to illustrate the great difficulty of judging the true fiduciary responsibility of a director.

You might think that where everything is fully and fairly disclosed, and an honest business decision is made by a disinterested majority of a board not to proceed, a director, acting in good faith, would not breach any fiduciary obligation by acting upon the matter disclosed to the extent the corporation decided not to proceed. But the law is not this clear, as I shall try to show you.

In Turner v. American Metal Co., the Court made the following statement:[7]

> "Up to 1920, American Metal had invested but $90,000; its 10% share of the cost of Climax. Whether American Metal should invest an additional $855,000 was a matter of business policy for the board of directors to decide. Its decision not to purchase the Climax stock from the participants we are persuaded was made in good faith and in the exercise of honest judgment. Under settled law, such a corporate act within the corporate powers is valid and binding upon the corporation and its stockholders. The internal affairs, questions of policy of management, and expediency of contracts of a corporation are subject to the control of a board of directors, and in so far as those directors are honest, capable and independent, their judgment is final. [Citing authorities.] The power of a board of directors is well stated in Pollitz v. Wabash R. R. Co., supra, 207 N.Y. page 124, 100 N.E. page 723: 'They were the exclusive executive representatives of the corporation, and were charged with the administration of its internal affairs and the management and use of its assets. Their corporate acts, within the powers of the corporation, in the lawful and legitimate furtherance of its purposes, in good faith and the exercise of an honest judgment, are valid, and conclude the corporation and the stockholders. Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, * * *.'"

The Turner case is factually quite different from Irving Trust Co. v. Deutsch,[8] where a "corporate opportunity" was held to exist.

There the opportunity was to buy for cash a one-third share interest in a company having valuable radio patent

---

7. 268 App. Div. 239, 259-60, 50 N.Y. Supp. 2d 800, 819.

8. 73 F.2d 121 (2d Cir. 1934), cert. denied 294 U.S. 708 (1935).

rights sorely needed by Acoustic, the prospective corporate purchaser.

The board of directors, because of alleged inability to procure the necessary funds, decided not to take up the offer whereupon certain of the directors took it up individually and later profited from the public sale of the shares they purchased. The lower court's dismissal was reversed with an opinion of Judge Swan of the United States Circuit Court for the Second Circuit, containing broad language as follows, which, aside from the factual differences in the cases, might appear to be very different from what is found in the Turner opinion:

> "The theory of the suit is that a fiduciary may make no profit for himself out of a violation of duty to his cestui, even though he risk his own funds in the venture, and that any one who assists in the fiduciary's dereliction is likewise liable to account for the profit so made. [Citing authorities.] Concretely, the argument is that members of the Biddle syndicate, three of whom, Messrs. Biddle, Deutch, and Hammond, were directors and one, Mr. Bell, its agent in procuring the contract, appropriated to themselves Acoustic's rights under its contract with Reynolds & Co. for 200,000 shares of De Forest stock, when as fiduciaries they were obligated to preserve those rights for Acoustic and were forbidden to take a position where personal interest would conflict with the interest of their principal. The other defendants are claimed to have assisted in their dereliction. In answer to this argument, the defendants do not deny the principle, but dispute its applicability to the facts." at 73 F.2d 123)
>
> * * *
>
> "The main defense asserted is that Acoustic by reason of its financial straits had neither the funds nor the credit to make the purchase and that the directors honestly believed that by buying the stock

for themselves they could give Acoustic the advantage of access to the De Forest patents, while at the same time taking a stock speculation for their own benefit. . . . In Wing v. Dillingham a director of a corporation completed payments on timber land which the corporation had an option to purchase but was unable to pay for; the director taking title to the land and giving the corporation an option to acquire it by repaying his advances within six months. Long after the six months, and without repayment of the advances, the corporation's receiver was held entitled to avoid the transaction and require the director to account. . . . The defendants' argument, contrary to Wing v. Dillingham, that the equitable rule that fiduciaries should not be permitted to assume a position in which their individual interests might be in conflict with those of the corporation can have no application where the corporation is unable to undertake the venture, is not convincing. . . ." (73 F.2d at 124)

* * *

If the directors are uncertain whether the corporation can make the necessary outlays, they need not embark it upon the venture; if they do, they may not substitute themselves for the corporation any place along the line and divert possible benefits into their own pockets. 'Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions.'"

In Litwin v. Allen,[9] where the investment was held not to be a corporate opportunity, the opinion of Justice Shientag includes the following:

"A director of a corporation is in the position of a fiduciary. He will not be permitted improperly to profit at the expense of his corporation. Undivided loyalty will ever be insisted upon. Personal gain will be denied to a director when it comes because he has taken a position adverse to or in conflict with the best interests of his corporation. (at 25 N.Y. Supp. 2d 685)

---

9. 25 N.Y. Supp. 2d 667 (Sup. Ct. 1940).

"In order to permit the appropriation in this action of defendants' Alleghany stock profits for the benefit of Guaranty Company on the theory of corporate opportunity, plaintiffs would, under the authorities, be required to establish (a) that the shares were in contemplation of equity offered to the Guaranty Company, i.e., were either offered to it in terms or offered to defendants as fiduciaries of Guaranty Company, or (b) that Guaranty Company had some legitimate right or expectancy in these shares; that is, as expressed by the Appellate Division of this Department, that the circumstances imposed upon the defendants a 'mandate' to buy for the corporation. Hauben v. Morris, 255 App. Div. 35, 46, 5 N.Y.S. 2d 721, affirmed 281 N.Y. 652, 22 N.E.2d 482. This corporate right or expectancy, this mandate upon directors to act for the corporation, may arise from various circumstances; such as, for example, the fact that directors had undertaken to negotiate in the field on behalf of the corporation, or that the corporation was in need of the particular business opportunity to the knowledge of the directors, or that the business opportunity was seized and developed at the expense, and with the facilities of the corporation. It is noteworthy that in cases which have imposed this type of liability upon fiduciaries, the thing determined by the court to be the subject of the trust was a thing of special and unique value to the cestui: for example, real estate, a proprietary formula valuable to the corporation's business, patents indispensable or valuable to its business, a competing enterprise or one required for the growth and expansion of the corporation's business or the like. To put it quite simply, the question to be determined is, have the directors profited at the expense of their corporation; have they gained because of disloyalty to its interests and welfare?

"As the foregoing review of the evidence establishes, this question must here be answered in the negative.*** [citing authorities] (25 N.Y. Supp. 2d at 685-86)

And in Loft v. Guth,[10/] the well-known Delaware holding that Pepsi Cola was a corporate opportunity of Loft Incorporated, the candy company:

---

10. 23 Del. Ch. 138, 2 A.2d 225 (Ch. 1939), aff'd, 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939).

"Such are the fiduciary duties and obligations of an officer and director of a corporation that if a business opportunity comes to him which is in the line of his corporation's activities and of advantage to it and especially if really intended for it, the law will not allow him to divert the opportunity from the corporation and embrace it as his own." (At 2 Atl. 2d 238-239)

Finally, there is Blaustein v. Pan American Petroleum & Transport Co.[11] holding that Standard Oil of Indiana, the parent of Pan American, could acquire oil producing properties located nearer the refinery of its subsidiary than its own refineries without thereby taking over a corporate opportunity since as the Court of Appeals found there was no proof at the time the properties were acquired "they were recognized or identified as properties in which Pan American had a tangible expectancy -- which in its nature was inchoate." The trial court's opinion states:

"In such a situation it is not enough for the defendant to prove that the charges made by Indiana were the usual charges, that the terms of the arrangements between Indiana and Pan Am were fair and reasonable, and usual and ordinary, as the defendants have sought to do. While such proof is also essential, it must first be shown that the very act of taking over the normal business opportunities of Pan Am at a profit was justified. What constitutes justification will of course depend on the circumstances of each case. The Deutsch case has held that mere financial inability of Pan Am, for one thing, would not be sufficient excuse. But until justification is shown, the fairness of the deal does not obviate liability." (at 21 N.Y. Supp. 2d 722)

There are also later cases; for example, Maclarey v. Pleasant Hills, 35 Del. Ch. 39,109 A.2d 830 (Ch. 1954),

---

11. 293 N.Y. 281 (1944), affirming 31 N.Y. Supp. 2d 934 (App. Div. 1941) reversing 21 N.Y. Supp. 2d 651 (1940).

Johnston v. Greene, 35 Del. Ch. 479, 121 A.2d 919 (Sup. Ct. 1956) and American Investment Co. of Illinois v. Lichenstein, 134 F. Supp. 857 (E.D. Mo. 1955).

But the ones I have quoted from above establish the basic doctrine of director loyalty, and are the ones referred to regularly in the United States.

AHD: Resume here if you decide to omit pp. 7-15.

To do their job, directors must, of course, be furnished by management with necessary corporate information. In most publicly-held corporations; the board should meet at least monthly. All essential information necessary for action to be taken at a meeting, including monthly financial statements, should be available to the directors for study, if possible, before the meeting.

Between board meetings, most publicly-held corporations should have a standing committee, usually referred to as an executive committee, to handle the normal functions and to review really important matters. Extraordinary powers should be reserved for meetings of the full board which should always be kept fully informed.

At board meetings it would be well for the corporate legal advisor to be available or on call, if he is not a director, and for the corporate officer charged with accounting responsibilities also to be available or on call, particularly since directors derive a great deal of protection in most of our states from bona bide reliance on opinions

of reputable counsel and on financial statements represented to be correct by the internal corporate financial officer or independent auditors.

All reports of outside independent auditors, and any letters from them criticizing accounting methods or any accounting entry, should be furnished to all directors, and the directors, by an audit committee of outside directors, should determine the scope of the independent audit, participate in the arrangements made with the auditors for making the audit, and ask them if they are fully satisfied with the accounts, the internal audits, and the cooperation they are getting from company officers and employees.

It is important that the directors be made fully aware of all circumstances surrounding the selection or nomination of the independent auditors and that they satisfy themselves as to the integrity and independence of the auditors.

Decisions which vitally affect earnings, even if in accordance with generally accepted accounting practices, must in the first instance be determined by the directors. It is they and the officers who are primarily liable on the accounting statements if they can't prove reasonable care and investigation.

Let us next consider the basic concepts of our Securities Act of 1933 and Securities Exchange Act of 1934.

The Securities Act of 1933 is essentially a disclosure statute calling for truth in the sale of securities. It regulates the use and content of prospectuses in connection with the new public issues of securities or the public sale of outstanding securities by controlling persons.

It does not regulate whether a particular company can or cannot sell securities or whether a particular security can or cannot be sold. It deals with disclosure and not approval.

But it would be less than candid not to admit that the Securities and Exchange Commission, by withholding effectiveness of a registration statement under this Act because of dissatisfaction with its factual content, does not have some regulatory authority with respect to what securities are actually marketed and when they are marketed in the United States.

Earlier this year, Genesco did a public secondary offering of common stock. For about six months our Commission refused to permit the registration statement to become effective on an accelerated basis. Finally, it agreed to acceleration.

Acceleration of effectiveness goes to the heart of timing an underwriting. Where the SEC refuses to cooperate and accelerate, it is almost impossible to work out satisfactory underwriting arrangements and as a practical matter the offering cannot be made.

The Securities Exchange Act of 1934 has to do mostly with the regulation of trading in outstanding securities. Under this Act the Commission supervises the operations of our stock exchanges and of our broker-dealers in their day-to-day trading and brokerage activities both on stock exchanges and in the

over-the-counter and underwriting markets.

This is the Act which regulates solicitations of proxies in the United States and requires the use of proxy statements. It also provides for short-swing profits liability of officers, directors and 10% stockholders.

Mr. Milton H. Cohen of Chicago, who recently headed up the SEC's task force for a special study of our securities markets has published a challenging article entitled "Truth in Securities Revisited" in 79 Harvard Law Review 1340 (1966) suggesting the need for overall revision of our securities acts -- both the 1933 Act and the 1934 Act -- so that they will be better coordinated, particularly in their approach to registrations and the maintenance in public government files of up to date corporate information. We shall no doubt see developments in this direction in the years ahead.

By amendments in 1964, the proxy and short-swing profit provisions of the 1934 Act were extended to unlisted companies having assets in excess of $1,000,000 and more than 500 public stockholders. Thus, whether or not a publicly-owned company's stock is listed on a stock exchange, today it is subject to these provisions of the 1934 Act -- unless it is an insurance company subject to similar provisions under State statutes, or unless it is a very small company indeed.

Under Section 16 of the 1934 Act directors must report all purchases and sales of equity securities of the company of which they are a director. These reports are required monthly. Under a recent interpretation by our Securities and Exchange Commission, which with great respect I doubt rests

on sound authority and will certainly be contested, the director must, absent very special circumstances, include in his reports, purchases and sales by his wife and by any relatives who occupy the same house with him, whether or not in any common-sense way the securities of the wife or relatives are owned by him directly or indirectly. Such reporting could complicate both his estate and his taxes.

Section 16(b) provides that if a director purchases and sells or sells and purchases securities of his company within a period of six months, he is liable to his company for his profits, irrespective of whether, in engaging in any such transaction, he possessed or used inside information not available to the general public, and irrespective of whether the other party to the transaction suffered any loss or damage.

Purchases and sales are broadly defined and construed to include such things as mergers, although the trend in the recent past has been to limit, by SEC rule, the meaning of the terms to some extent, as the older interpretations resulted in much unnecessary hardship on insiders with no resulting benefit to the investing public.

Thus, the conversion of convertible preferred into common was originally construed for this purpose to be a purchase of the common, but a recent rule of the SEC[12/] reverses this interpretation. Profits, too, are broadly construed to mean the greatest possible difference between any purchase price and any sale price within six months, whether for tax purposes

---

12. Release 34-7826 of February 17, 1966 amending Rules 16b-8 and 16b-9.

or economically there was any profit at all.

In registering a security under the 1934 Act, the issuer must file a comprehensive registration statement on Form 10, and must thereafter file annual reports on Form 10-K and interim reports of material events on Form 8-K.

The registration statement, in addition to describing the corporation's business, its directors and management, sets forth the facts with respect to control, includes audited financial statements for the preceding year, and files material contracts.

In order to report on control, the corporation frequently must obtain information about beneficial ownership of its shares from its officers, directors and major stockholders. This, again, is a matter of personal disclosure which must be obtained by questionnaires to the individuals concerned, as distinguished from corporate disclosure, although the document making the ultimate public disclosure is a corporate document.

Directors, however, have a responsibility to see that this corporate document is true and accurate and that appropriate information concerning beneficial ownership is obtained from the directors and officers.

Material changes in corporate affairs, that is in its business, its control, its outstanding securities, new material contracts, or important financial developments, must be reported on an interim basis within 10 days of the end of the month in which such a change occurs. This is designed to

keep the annual reports, which must be filed within 120 days of the end of the corporate fiscal year, reasonably up to date.

In addition to these reports, a corporation whose shares are registered under the 1934 Act must furnish stockholders annually before the date of the annual meeting with proxy statements and annual reports containing audited financial statements.

The proxy statements include information about the stockholdings and remuneration of management, as a group, and individually by the three highest paid officers and any director who, in any case, received more than $30,000 in the preceding fiscal year. In addition, the statement must describe any contractual compensation arrangements and any option arrangements, with information about the grant and exercise of employee stock options during the fiscal year.

Let me note again that the 1934 Act now has been amended to require that all companies with shares registered under it, whether or not listed on a national securities exchange, must furnish this information, including audited statements.

Even if a company does not solicit proxies, it is no longer possible, as it was for many years, to avoid preparing and furnishing proxy statements for stockholders' meetings. In the past, some companies simply did not solicit proxies in say two out of three years where enough of their stock was closely held so that the directors knew there would be a quorum and they would be re-elected without proxy solicitation.

Despite the differences I have mentioned between our original issue and public sale of control stock act

of 1933 and our trading in outstanding securities act of 1934, there are marked similarities.

Both Acts impose liability for making false statements in prospectuses, registration statement or other filings, and for this purpose the omission of material information is treated the same as misstatements of material information.

The important sections of the 1933 Act for this purpose are Sections 11, 12 and 17, and the important sections of the 1934 Act are Sections 9 and 10.

While our courts might have reached the conclusion that a cause of action arising primarily under one of these sections was not a good cause of action under another, the tendency has been in the other direction. Today, complaints about misstatements or omissions are generally grounded on all of these sections with the hope that at least one will catch on.

The sections differ in applicable statutes of limitation, whether the plaintiff and defendant must be in privity of contract, whether there must be reliance upon the misstatements, and whether the plaintiff must prove scienter, fraud or deceit.

I do not have time today to do more than mention these areas of difference which our courts have begun to articulate in a growing body of decisions.

I want now to turn to Section 10b of the 1934 Act and Rule 10b-5 thereunder, since this is the section and rule most frequently referred to in connection with directors' disclosure responsibility, and is the section primarily involved

in the recently decided Texas Gulf Sulphur case[13] and its predecessor, the Cady, Roberts case.[14]

Section 10b covers transactions in any security (not just listed securities), and it provides that it is unlawful for any person (not just insiders), by use of interstate commerce or the mails (which we refer to as the federal jurisdictional means) to use or employ in connection with the purchase or sale of any security, any manipulative, deceptive or other fraudulent device or contrivances in contravention of the Securities and Exchange Commission's rules.

Rule 10b-5, promulgated under this statute, says it is unlawful for any person by use of interstate commerce or the use of the mails to employ any device, scheme or artifice to defraud, to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make what is stated not misleading, or to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 10b-5 and Section 10b are, indeed, very broad. For years it was uncertain whether a private person could bring an action for damages based on a violation of Rule 10b-5, but it has now been clearly established that there is

---

13. ___ F. Supp. ___ (SDNY 1966), CCH Fed. Sec. Law Rep. 91,805.

14. 40 S.E.C. 907 (1961).

a private right of enforcement and there may be civil liability -- as well as criminal liability -- for violation.

In most cases brought by our Securities and Exchange Commission for enforcement of Rule 10b-5, the Commission has sought the relief of suspending or deregistering a licensed broker-dealer who has been a participant in a violation.

The question of dollar damages by a purchaser or seller of shares has not been in issue. This was the situation in Cady, Roberts which is a registered broker-dealer. That case involved alleged misuse of confidential information obtained by a director in the employ of the registered broker-dealer.

Texas Gulf, on the other hand, is not concerned with disciplining a broker-dealer. Rather it seeks dollar restitution directly from the corporation itself and its directors and officers to persons alleged to have been damaged by alleged violations of Rule 10b-5.

The difference in the relief sought is a giant step in the concept of director disclosure, since under the Cady, Roberts approach, a director who was not himself connected with a broker-dealer was not a target in a governmental suit.

In Cady, Roberts a registered representative of that firm was also a director of Curtiss-Wright. At a board meeting on November 25, 1959 the dividend of Curtiss-Wright was reduced and at 11:00 A.M. that day the board authorized transmission of this action to the New York Stock Exchange. The telegram was given to Western Union at 11:12 A.M. but wasn't delivered to the Exchange until 12:29 P.M.

At a recess of the meeting, the director-registered representative, who was under the impression that the reduction had been publicly announced, called a partner of his employer, Cady, Roberts, and left a message that the dividend had been cut. Upon receiving this information, the partner made various sales, including short-sales, in the stock of Curtiss-Wright for discretionary accounts of customers, including some for the account of his wife.

After the news became public later the same day, the price of Curtiss-Wright's stock fell some 15% in a matter of hours and trading was suspended.

The New York Stock Exchange fined the partner of the broker-dealer $3,000 and, in addition, the Securities and Exchange Commission suspended his firm from doing business on the Exchange for 20 days, quite a substantial economic fine.

Here, the violation was by a person, i.e., Cady, Roberts (a stock exchange firm and a registered broker-dealer) which was not itself a director. The SEC emphasized that Rule 10b-5 applied to "any person" and in any event, because of the firm's relationship with its registered representative -- a director, the firm should be regarded as an insider with responsibilities under Rule 10b-5 when it possesses inside information.

It is astonishing to consider this case against the limited applicability of Section 16, the short-swing

profits section, where liability extends only to the director himself, the question of possession or use of confidential information by the director is not involved, and reliance by the non-director party to the transaction, and privity are not factors. On the facts, one can hardly quarrel with the Cady, Roberts findings since there was a misuse of inside information obtained as a director.

But what about the civil liability of Cady, Roberts to persons to whom it sold stock for its customers? Bear in mind the difficulty of establishing that particular stock came from Cady, Roberts since the transactions were through the impersonal medium of the New York Stock Exchange and the Stock Exchange Clearing House where actual deliveries of securities are only made to clear a net long or short balance of a member firm. Must a plaintiff prove privity? What if the stock goes down four points and then three days later goes down five points more for an unrelated reason? Would the broker-dealer be liable for $4 or for $9? If the buyer can rescind the transaction, the liability is really for the larger figure.

From our standpoint, one statement by Chairman Cary of the Securities and Exchange Commission, who wrote the Cady, Roberts opinion, is particularly important.

He said that if "disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we [that is, the Commission] believe the alternative is to forego the transaction." In other words, under the circumstances the broker-dealer, in the opinion of

the Commission, should not trade for customers any more than for his own account.

This is amplified by the complaint in Texas Gulf Sulphur.

Texas Gulf allegedly made an important copper find near Timmons, Ontario in November 1963 as a result of drilling activity. The find was unannounced and actually went unreported for a time while the company attempted to buy surrounding property, although, according to the allegations in the SEC's complaint, certain of the corporate officers and of course those of its mining employees and assayists who analyzed the drilling core must have known that it was both valuable and material. Mining is a complicated business, and the issue is did they?

In the period from November 12, 1963 to and including April 16, 1964 several of the officers and other employees who were acquainted with the discovery made purchases of the company's stock or acquired options on the company's stock, both from the company (that is, employee stock options) and from others, allegedly without disclosing the find to the seller or optioner (or allegedly without disclosing the correct facts to the outside corporate directors who granted the options).

On April 12, 1964, after being prodded by the Exchange because of recurrent rumors and articles in Canadian mining journals, the company issued a press release characterizing the Timmons situation as a "prospect" which

required more drilling before it could be evaluated, and denying responsibility for the rumors and characterizing them as exaggerated.

After this press release, drilling continued. On April 15 the company's geophysicist purchased 200 shares of Texas Gulf, and on the morning of April 16, the secretary of the company purchased 600 shares just before a second press release, announcing "a major discovery," was handed to the press.

Immediately after the second press release was handed to the press but before the information was on the broad tape, an outside director purchased 2,000 shares for a family trust of which he was a trustee, and another outside director telephoned a fellow officer of a bank to be on the lookout for good news about Texas Gulf. The bank officer thereupon purchased shares for certain discretionary accounts in which neither the bank nor the Texas Gulf director had any interest except for their general business relations with the account owners. Later in the day, after the announcement was on the broad tape, the second outside director purchased some shares for himself.

Our Securities and Exchange Commission brought suit in the Federal District Court for the Southern District of New York complaining that all of these purchases from November 12, 1963 through April 16, 1964 were in violation of Rule 10b-5 since they were made by Rule 10b-5 insiders without appropriate prior disclosures about the find to the stockholders as a body.

Also, some 50 private lawsuits have been commenced against Texas Gulf, its officers and directors for losses

alleged to have been sustained by the plaintiffs because of alleged violations of Rule 10b-5.

In Texas Gulf the Commission goes far beyond its position in Cady, Roberts. It seeks to require insiders (including employees who were neither officers nor directors) who bought stock on the Stock Exchange from sellers, who simply wanted to sell and didn't care to whom they sold, to make rescission offers to the sellers, and, in addition, to make restitution to sellers who sold to "tippees" of such insiders, even though the insider himself did not profit. It seeks to cancel options acquired by insiders and, possibly, to require the issuer itself to make restitution to those who sold stock in the period between the two press releases of April 12 and April 16, 1964. The measure of recovery and restitution is unclear, and I have already alluded to the great difficulty of determining what appropriate damages would be, even assuming that Rule 10b-5 is held by the appellate court to have been violated.

Judge Bonsal of the Federal District Court in New York decided the case on April 16, 1966. Since then both the SEC and certain of the defendants have announced that they intend to appeal the decision to the Court of Appeals for the Second Circuit.

Judge Bonsal held in favor of all defendants except the company secretary and the company geophysicist (the latter was neither an officer nor a director) who purchased on April 15 and April 16, 1964 before the April 16 press release was given to the press.

Judge Bonsal held that Rule 10b-5 could be violated without the existence of common law fraud or the elements (scienter, reliance and privity) necessary to establish such fraud, that insiders subject to the disclosure requirements of the Rule "may include employees as well as officers, directors and controlling stockholders who are in possession of material undisclosed information obtained in the course of their employment" but that there could be no violation of the Rule for non-disclosure unless the undisclosed facts were "material." He said this meant information which in "reasonable and objective contemplation" might affect "the value" of the securities or "which, if known, would clearly affect 'investment judgment.'"

The Judge quoted with approval the definition of "material information" from an article by Mr. Fleischer in 51 Va. L. Rev. 1271 at 1289 (1965) entitled "Securities Trading and Corporate Information Practices," as information which is "essentially extraordinary in nature and....reasonably certain to have a substantial effect on the market price of the security if disclosed."

Judge Bonsal held that the information about drilling up to 7 P.M. on April 9, 1964 when the third drill hole was down 421 feet and showed 366 feet of mineralization was not material and that accordingly purchases before then did not violate Rule 10b-5, but that from then forward, since it was then certain the ore zone had a third dimension, there was "real evidence that a body of commercially mineable ore might exist" and that "those with knowledge of the drilling results had material information." Consequently, the purchases after 7 P.M. on April 9, i.e., those by the company geophysicist

and its secretary, were illegal.

The Court carefully pointed out that the briefs submitted and the decision rendered were limited to the question whether Rule 10b-5 had been violated "reserving for later hearing the issue of the remedy to be applied in the event such violations are found."

This leaves open the question of what elements of common law fraud (scienter, reliance or privity), if any, must be found to be present in order for a dollar judgment to be entered, whether the claimant be a private litigant or the Securities and Exchange Commission -- something we should know more about after the Texas Gulf case and the related private suits have wended their way through our courts.

So far, our cases have held that privity, or as one judge said, a semblance of privity (which may mean not actual privity but only that chronologically the plaintiff sold while the misstatement or failure to disclose was current), is an essential element of the case, but the Commission has disagreed.

Judge Bonsal refused to uphold the Commission's charge that the first press release on April 12 was misleading or operated as a deceit in violation of Rule 10b-5, even in the face of a finding that material information did exist at the time of this release. At that time before the subsequent drilling was completed it was still accurate, so he concluded, to characterize the Timmons operation as a "prospect" requiring more drilling for proper evaluation.

Also, the Court held that the purchases by the two outside directors, and the bank affilate of one, after the press release had been handed to the press on April 16,

thereby "making the announcement," did not violate Rule 10b-5.

Just when is inside information to be deemed publicly disclosed for the purpose of Rule 10b-5? What is public disclosure? Publication in a regional mining journal, or a local paper or general information in a financial paper may not be enough, or at least the SEC so contended in Texas Gulf. Must the insider wait, as the SEC urged the Court, a reasonable time after the press release, thus giving the public time to absorb the announcement? Brokers, bankers, journalists, and tape watchers, of course, see the broad tape. But how many others do?

The Court in Texas Gulf held that "it is the making of the announcement that controls" and if this is unfair to the public stockholders, the SEC or Congress (if the SEC lacks authority) and not the Court is the proper agency to promulgate a different rule. Nevertheless, I believe that from now on an insider will only be asking for trouble if he buys or sells on the day of such a press release without waiting for public absorption.

Without attempting to speculate the outcome of the case on appeal, or the damages which may be held payable by any defendant if liability is found, let us turn to the implications of the complaint from the standpoint of director disclosure.

We do not have time today to discuss further the special problems raised for corporate employees (the expert geologist, the president's secretary, or the drilling boss) who are not officers or directors, except to say that such persons may, in some cases, have fiduciary responsibilities by their positions which prohibit trading on the basis of

undisclosed inside information. At least Judge Bonsal has so determined for the geophysicist in the Texas Gulf case.

In December 1965, the New York Stock Exchange put out a booklet called "The Corporate Director and the Investing Public." There, the Exchange points out that the conduct of corporate directors is often controlled more effectively by public opinion than by law -- 20 million shareholders in the United States is a considerable body of public opinion.

The Exchange says that a listed company, in addition to publishing annual and quarterly earnings reports, and being required to make prompt dividend announcements and prompt announcements of proposed acquisitions, mergers, stock splits and major management changes, often faces the problem of just when announcements of such events should and must be made.

And, a company should not give information to a directly inquiring investor which it would not give to others and to the press.

The Chairman of our Securities and Exchange Commission in a recent speech criticized the practice of some companies in giving special interviews and information to securities analysts, mutual funds and large stockholders, before the same information is made available to all stockholders. It is often a delicate matter; sometimes, false rumors about an impending event leads the Exchange to inquire of the corporation what is up and request press clarification at a time when full disclosure may be damaging to the corporation and shareholders and arbitrageurs.

When this happens, the corporation must issue as

candid a statement as possible right away and not put out something which is misleading. In a mining company engaged in underground drilling which must assay and evaluate metallurgical content, various ore percentages, feasibility, probable drilling costs and profitability from scattered drill holes, this may be very difficult and possibly misleading, particularly in rough topography, where the work is at great depth and there are serious water problems.

Until a public statement has become appropriate and is made, the directors should refrain, if the development in question may be material, from trading in the company's securities.

The Exchange says that since many United States corporations are involved on almost a weekly basis in acquisition proposals, product development, new contracts and other things which may be material from the standpoint of the stock market, directors and officers, despite the fact that stockholders want them to have meaningful investments in the corporation, should buy or sell stock only in the following circumstances:

1. Under a periodic investment program where the timing of transactions is outside the individual's control;

2. For a 30-day period commencing one week after release of the annual report. Presumably in this period all inside information will have been made public, though this depends on the time of issuance of the annual report;

3. Immediately following the release of quarterly results, if the insider first "contacts" (sic) the chief executive and it is confirmed that nothing unusual is up;

4. Immediately after a proxy statement or prospectus has been disseminated, if again the insider first "contacts" (sic) the chief executive; and

5. In times of relative market stability and stability in the corporation's operations, if again the insider first "contacts" (sic) the chief executive.

It seems to me that these standards are more stringent than necessary. Checking with the chief executive immediately after an up to date prospectus has been disseminated may be supererogation but anyhow the chief executive can't grant absolution for civil liability. I agree that it is extremely difficult to determine whether a particular corporate event or proposal is material from the stock market standpoint and further, that it is often difficult to know just when various negotiations, such as a merger, should be disclosed because the disclosure itself may prevent the transaction from taking place.

Nevertheless, it seems to me that unless directors have been advised by the Chairman or President that they should refrain from engaging in securities transactions because of the existence of undisclosed inside information which for good Company reasons cannot yet be disclosed, they

should be free to trade within the statutory limitations of Section 16 of the 1934 Act as so far interpreted by the courts and particularly Judge Bonsal's recent decision.

Beyond this, the directors must see to it that the corporation discloses as promptly as is reasonably possible events which, in their opinion, they, with the advice of counsel, consider material.

Mining companies, in particular, are often faced with difficult problems in this respect, since premature disclosure of a mining discovery may make it unduly expensive for the company to round out the real estate or mining leases or properties necessary for tailings in order to make the new mining operation economically feasible without the payment of exorbitant amounts for the peripheral but essential properties. Snow on the ground, frozen earth, great depths, mountainous terrain and water problems may present difficulties in drilling, and metallurgical and assay problems may present other difficulties which cause delay in proving up a promising prospect.

I hope I have given you some insight as to the directions in which our courts are moving in respect of director disclosure.

With larger and larger numbers of stockholders in all our countries, I believe that disclosure, although it will be sharply litigated for years to come, will in the end be extended rather than diminished, and that directors will

find that they must disclose as promptly and as effectually as possible any material corporate event and, pending disclosure, refrain from engaging in transactions in the corporation's securities.

Some of the disclosures will be by the annual reports, interim reports, prospectuses, proxy statements and insider stock purchase and sale reports required under the various laws of our countries; others will be by complete, adequate and accurate press release or public announcement in newspapers of general and wide circulation or of releases to stockholders prior to the filing of formal governmental reports.

Directors sit on a powder keg, when they or their intimates -- secretaries, lawyers, experts, accountants, engineers or geologists -- have undisclosed material corporate information. They should do everything possible to build stockholder and public confidence in them and their enterprise in order to see that such information, if material, is disclosed in both a timely and proper manner.

Grover Cleveland said "Public office is a public trust."

Justice Cardozo said that "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place."

Directors do indeed have great responsibility. They are managers of their own and "other peoples' money." In this sense they are fiduciaries not in the strict sense of trustees who can have no dealings with the trust, for normally, directors can buy and sell their corporation's securities without incurring liability, but in the highest sense of fiduciary responsibility as directors of a publicly-owned company who have obligations to the government, to the corporation's stockholders, and in some sense at least to members of the public who might become stockholders.

It would not, I submit, add to the public good to forbid directors to be stockholders and to forbid them to buy and sell. We should think a long time about that, and what it entails.

But the present laws and decisions do circumscribe a director's rights to buy and sell without accountability. Directorships of public corporations will, I believe, in the future tend to become more and more positions of quasi-public importance carrying heavy responsibilities. Responsible directors do not wish to escape responsibility for acts which they can know, understand and appraise.

They understand that they are in a sense in a position fraught with fiduciary responsibilities. They accept and want to discharge their duties correctly.

But, I submit, it is not in society's best interest to penalize them for acts done in good faith, which were not improper when committed; otherwise able men will think twice about assuming such heavy responsibilities despite an innate sense of public duty.