NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
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RESPONSIBILITIES AND LIABILITIES IN CORPORATE LIFE

An Address By

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Securities and Exchange Commission

November 18, 1971

The Conference Board
The Waldorf-Astoria
New York, New York

I am very pleased indeed to participate in your Conference on new challenges and new directions for the board of directors. I have long admired the work of the National Industrial Conference Board. It has a great deal in common with the SEC. Each of us operates one of the most important information factories in the world. At 500 North Capitol Street, in Washington, we maintain the biggest gold-fish bowl in town, in which some 10,000 corporate fish are required to disclose their figures every three months. This exercise is not exclusively for the benefit of the stock-holders to whom the directors of these corporations have a direct and immediate responsibility. It is for the benefit of the entire investing public. I bring this to your attention today because it illustrates the degree to which the range and scope of corporate responsibility has been expanded. Today, you operate your corporations in a climate of rising expectations. You have performed so successfully in the economic realm and in the technological realm that you are expected to contribute increasingly to the solution of broad social and public problems.

To grow and meet the economic needs, public and private, which confront us as a nation, you will require increasing amounts of the public's savings.

Springing out of these developments, you are increasingly exposed to new and substantial responsibilities in your capacity as directors and officers--you have a new set of responsibilities for providing the public with information about your economic problems--and you are called upon to function in an increasingly broad and active forum which, although it has many facets, can be characterized as the arena of corporate democracy. The SEC is involved with you in these new and vital areas of corporate responsibilities and it is this I would like to discuss with you today.

First, I think we should note that the broad public interest in our corporations and the responsibilities which flow from them are related to the unique ability of the American economy to grow, to develop new services to the public and adapt itself to new conditions. The ownership in our corporations is shared by 30 million Americans. Another 70 million Americans have an indirect stake in the progress of these corporations through their participation in pension plans, life insurance policies and mutual funds. It is this broad public stake in the ownership of our plants and equipment, together with the information and disclosure of our economic performance which makes our securities markets the best in the world. These markets are a major national asset and, as other countries catch up with our technology, our ability to mobilize capital quickly and in large amounts may be our last vital advantage in world competition. The fact that the American investor is the most informed investor in the world certainly contributes vitally to the fact that you can raise more capital for each dollar of earnings than your competitors abroad and that you need not pay out so much in dividends in order to maintain capital values. This enables American companies to pile a larger proportion of earnings back into expansion than their competitors abroad.

Surveys of shareholders of major corporations show that 85% of these shareholders are people who buy and add to their shares over many years. It is this group of existing shareholders, adding quietly to their investments, which supplies much of the money needed for corporate growth. This fact points up the immediate self-interest in keeping existing shareholders fully informed of corporate developments.

Second, the demand for corporate responsibility has had its strongest impact on the machinery for corporate democracy as spelled out in the SEC's proxy rules. We have had to weigh demands for presenting more questions at greater length at more company meetings in the light of maintaining the cost and effectiveness of the procedures of corporate democracy and the need to keep operational authority and responsibility firmly on management, if we are to avoid impairing corporate performance and blurring corporate responsibility. We are trying very hard to maintain the opportunity for individual shareholders to put forward proposals and to press for appropriate corporate action without unduly burdening corporate management, which has a fiduciary responsibility to <u>all</u> shareholders, and diverting it from a fundamental responsibility for economic performance.

Thirdly, I view the problem of corporate information as one that has been growing in recent years. The SEC takes the view that information relevant to stock values belongs to the investing public and that they are entitled to get it promptly. This position has made the press release frequently a more important instrument of financial disclosure than the documents filed with the SEC and the annual quarterly reports you send to your shareholders. The information which is collected in our files in Washington needs to be analyzed, evaluated and disseminated in order to serve its purpose in the investment markets but the press release is virtually "instant dissemination". We want to encourage dissemination by whatever means possible. Meetings between management and security analysts are important. I have recently noted a controversy over whether these meetings should be open or not. Although we do not believe we are in a position to decide this question, we do feel that open meetings are advisable from many points of view. It seems to me that you reduce the degree of liability by keeping the meetings open, and making full disclosure. However, the only thing which the SEC explicitly requires is that new information and new developments which are brought out in a closed meeting be promptly disclosed to shareholders and the public, preferably by putting it on a newswire. When new and material information is given to a single securities analyst in a private meeting an obligation is created, in my opinion, to make public disclosure of that information.

Applying and living by that rule will take discernment and judgment but I see no other way to be fair to existing shareholders and the investing public. We want to continue the flow of information to analysts but we cannot tolerate a privileged position for large institutions in access to corporate information any more than we can tolerate the use of such information by insiders.

What kind of responsibility is created for the corporation when an analyst constructs his own projection of earnings? We have recently seen a situation where some investment firms put out a projection of substantially increased earnings. The company was silent. When the company's earnings, although they increased, failed to measure up to the analyst's projections, there was a selling wave and a huge drop in the price of the company's stock. What can we learn from this? It seems to me that when the management knows that earnings projections substantially in excess of its own expectations are being given to the investing public, the company's own self-interest as well as its obligation to investors calls for some form of public demurrer. Also, when a management confirms an analyst's private projection in a private meeting, it seems to me an obligation to make that projection public is created. These are difficult questions but they are very real. They can affect the hopes and aspirations of families and they cannot be swept under the rug. We must grapple and deal responsibly with them.

What kind of information is the investing public entitled to? I am going to try out on you some relatively new ideas which spring from my belief that the time has come to take a broader view of what is pertinent to investment values and the obligation to convey economic reality as management knows it to stockholders and investors. I believe the time has come when we should re-examine the question of the inclusion of projections, forecasts and appraisals in our disclosure framework.

What has the SEC's position been with respect to projections? Simply stated, the SEC has not required them and generally has not permitted them.

Our 1969 Disclosure Policy Study -- the Wheat Report -- reviewed the projection question. A number of experienced security analysts suggested to the Wheat Study that the SEC should permit "controlled" projections of sales and earnings in prospectuses and other documents filed with the Commission. On the other hand, lawyers, underwriters and company officials were generally opposed to the analysts' suggestion because of concern with the problems of civil liability under Sections 11 and 12 of the Securities Act. From a management standpoint, as you know, projections may change rapidly during a given year as changes occur in the factors on which they are based.

The Study concluded that the SEC's policy on projections should not be changed and emphasized that prospectuses and reports filed with the Commission are designed to elicit material facts. I quote from that Report:

> "A real danger exists, in the Study's judgment, that projections appearing in prospectuses and other documents filed under the securities laws and reviewed by the Commission would be accorded a greater measure of validity by the unsophisticated than they would deserve."

It should be noted, in passing, that this pronouncement, relating to 1933 Act filings, does not altogether carry over into other areas of Commission interest. Our proxy rules, for example, require that an annual report to shareholders must precede or accompany every proxy statement and with limited exception is not deemed "filed" with the SEC. Many such annual reports do include projections -- which are generally permissible therein -- if consistent with and not in violation of Rule 10b-5. Moreover, we have been more lenient on predictions found in press releases. While we have encouraged the release of factual information during the so-called "blackout" period while a company is "in registration", we have advised that predictions should be avoided at that time. We have not otherwise objected to releases which include projections for which there is a reasonable basis and which are responsibly prepared and appropriately qualified. It appears anamolous that projections of sales and income, deemed to be relevant for trading market purposes, were traditionally not required in prospectuses. As some of you may know, the requirements for an offering circular in England contained in their Stock Exchange Rules -- applicable to all English companies making public offerings -- include a statement as to the financial and trading prospects of the company together with any material information that may be relevant thereto.

It also is important to note judicial decisions in the related area of opinions and estimates. For example, in the Leasco case recently decided here in New York, the judge held that the prospectus for the exchange of Leasco's securities for those of Reliance Insurance Company was materially defective because it omitted an estimate of Reliance's "surplus - surplus." Another federal district court in Pennsylvania in 1970 found that the proxy statement relating to the merger of American Metal Climax Company and Roan Selection Trust, Ltd. was materially defective because it omitted the basis of evaluation of assets which AMC acquired from RST. Still another federal district court in 1969 in the Gamble-Skogmo case held that a merger proxy statement was materially defective because it failed to disclose appraisals of certain assets which reflected higher liquidating values than book values when there existed a plan to liquidate.

I have already stated that future developments in the disclosure area should at some stage involve the inclusion of predictions. How should this occur? After the re-examination study which I referred to, I believe that predictions should be permitted initially rather than required. But more work even in this specific area must be done before we reach definitive conclusions.

Let me now say a brief word about the liability that may flow from failure in corporate responsibility.

As I am sure you know, there has been a phenomenal increase in litigation involving corporate officers and directors. Some of this litigation arises from alleged violations of the federal securities laws -- for example, the insider trading prohibitions or the requirement of accurate disclosures in prospectuses. Other litigation has focused on the obligations of officers and directors under applicable state law to exercise reasonable care in the performance of their corporate duties and to fulfill their fiduciary responsibilities to the shareholders whose interests they represent.

Obviously, no one likes to be sued and there is an increasing reluctance on the part of otherwise qualified businessmen, attorneys, and investment bankers to subject themselves to the risk of liability arising out of service on corporate boards. This is not, in my view, a desirable thing. Now, more than ever, American corporations, faced not only with the usual business and financial problems but with issues of corporate social responsibility as well, need all the assistance and perspective they can get.

Of course, there is no way in which a director can prevent himself from ever being sued. There are, however, several ways in which the risk of liability can be minimized. In evaluating these risk-limiting methods, it is important to appreciate that their utility will -- and I think should -- be related to the essential question of whether the director has acted responsibly. It would be contrary to public policy to permit a director who has knowingly violated the federal securities laws or state corporate law by participating in a deliberate deception of public investors or in a deliberate looting of the corporate till to escape personal liability. On the other hand, a director who has acted responsibly, employing a degree of care that it would be reasonable to expect under the circumstances, should not be unnecessarily exposed to liability. The key questions, then, are what constitutes responsible conduct and what can be done to minimize liabilities that may arise even from such conduct.

The objective of appropriately minimizing directorial liability requires meticulous corporate planning and the structuring of effective internal controls. A director should know what his responsibilities are and the standards of conduct to which he subjects himself by joining the board. This should not be too difficult if only because the volume of litigation -- both governmental and private -- has resulted in fairly ascertainable guidelines. These guidelines now need to be applied with some precision by each corporation to its own affairs; the time has come for the American corporation to lay down its own internal laws and rules of conduct. If this is done, so that the company has an effective program of self-regulation, I think the likelihood of liability will be significantly reduced.

The second problem--how to protect directors when they have acted responsibly but are nonetheless the target of litigation--is integrally related to the delineation of responsible conduct. It is becoming almost routine nowadays for directors to insist on indemnification insurance. But indemnification, I submit, would not be appropriate in a case where the director knowingly and deliberately disregarded his obligations under securities or corporate law, even if an insurance company were willing to write a policy to cover that situation.

The Commission is currently confronted with a case where a federal district court found that certain officers and directors did not exercise due diligence in ascertaining the accuracy of representations made in a prospectus; since the representations were materially false and misleading, Section 11 liability existed as to those persons. The officers and directors had an indemnification agreement with the company, and the question is whether the company should be permitted to fulfill that agreement--in effect, to permit management to escape any liability while the company pays the judgment. The registration statement contained the usual language specified in Rule 460 under the Securities Act to the effect that any questions regarding indemnification of officers and directors would be submitted to a court of appropriate jurisdiction for a determination as to whether indemnification would be against public policy. The district court has requested the Commission's views on whether the court should make such a determination in light of the fact that the company does not wish to contest its agreement to indemnify.

Without intimating in any way what the Commission's position may be or whether the Commission will take any position, it is clear that this case presents at least two troublesome questions. First, should a company be permitted to consent to indemnification when the company is under the control of the very persons who would be indemnified? Second, should indemnification be permitted if the persons to be indemnified approached their responsibilities under the Securities Act with an attitude of indifference or conscious disregard?

Indemnification is a useful device to protect officers and directors from personal exposure to the inevitable risks of corporate life, however diligent and responsible these persons may be, but it should not serve to immunize the deliberately careless or irresponsible servant of the shareholders. There is little worthwhile in business--or elsewhere--that does not involve at least some risk; but the ultimate defense is the exercise of sound judgment, not the abdication of responsibility.