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NEW YORK STOCK EXCHANGE

The Corporate Director and The Investing Public

INCLUDING EXCERPTS FROM

CORPORATE DIRECTORSHIP PRACTICES*

*PREPARED JOINTLY BY NATIONAL INDUSTRIAL CONFERENCE BOARD, INC.

AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC.

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*Note: The chapter on Legal Responsibilities appearing in this booklet differs from the original chapter as it appeared in **Corporate Directorship Practices.** The revision gives consideration to the impact of new legislation and other pertinent developments since the original version was published in 1962.

Foreword

Corporate directors occupy positions of great influence, power, and responsibility. In establishing the basic objectives and broad policies of the companies they serve, directors play a vital role in assuring that the industrial and financial resources of the free enterprise system are wisely and competently managed.

In our highly developed and interdependent industrial civilization, corporate actions affect the lives and well-being of many millions of people. The interests of stockholders, employees, customers, and the general public must all be recognized by corporations and their directors. No corporation, in fact, can for long successfully ignore public opinion or expect that legislative bodies will not be responsive to that opinion. In a sense, the conduct of corporations and their directors is controlled more effectively by public opinion than by law—if only because the disregard of public opinion today usually can be counted upon to bring legislative action tomorrow.

Much of that public opinion these days is being voiced by America's shareowners—more than 20 million of them according to a 1965 survey conducted by the Exchange. Shareownership in America is increasing at the astonishing rate of about 1 million a year. As more individuals acquire stock, moreover, greater attention is focused on those who manage the nation's businesses. Directors have special responsibilities to the stockholders—the company owners who have elected them to serve as their representatives. By 1980, perhaps as many as 35 million shareowners will be directly affected by the management decisions of American industry.

Over the years a substantial body of law has evolved requiring that directors perform their duties in accordance with the best interests of the corporation and all of its shareholders. But these are only minimum standards.

The New York Stock Exchange, in cooperation with listed companies, has continually fostered the evolutionary development of responsible corporate conduct and high standards of business ethics. It has also promoted the growth of corporate democracy and the building of stronger ties between shareowners and directors.

The publication of this booklet for directors is part of this long-standing program and another of the Exchange's services to listed companies. Many corporate officials have urged the Exchange to undertake this project, pointing to the lack of conveniently available information dealing primarily with the relationships between directors, shareowners, and securities markets.

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This booklet includes in Part II excerpts from a booklet entitled **Corporate Directorship Practices,** published jointly by the National Industrial Conference Board and the American Society of Corporate Secretaries. More than 1,000 major corporations provided background for that authoritative study.

The selected excerpts include only the highlights dealing with subjects within the scope of this Exchange booklet. However, the chapter on Legal Responsibilities of Directors (which has been brought up to date by its author) is included in its entirety.

Corporate Directorship Practices also deals with a number of other subjects which are primarily the prerogatives of management and therefore beyond the scope of this booklet.

Preliminary drafts of this booklet were circulated among a representative group of prominent executives. The comment of the chairman of the board of a leading corporation seems especially pertinent:

> "It reads a bit to me like the Eleventh Commandment, but since the other ten are continually being reiterated, I suppose there is no harm in following the same practice with the Eleventh. Seriously though, officers and directors should certainly recognize their responsibilities in relation to their stockholders and the public at large, and this booklet succinctly points its finger at the 'do's' and 'don't's' of proper corporate responsibility. Therefore, I am all for it."

A number of specific recommendations in this area are set forth in the last section of Part I of this booklet. I trust that they will contribute to further the progressive improvement in relations between listed companies and the rapidly growing number of investors.

THE CORPORATE DIRECTOR and THE INVESTING PUBLIC

Part I

EXCHANGE VIEWPOINTS

The Department of Stock List of the New York Stock Exchange will be pleased to answer inquiries about matters covered in this Booklet or other questions relating to the Exchange and its relationships with listed companies.

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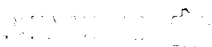

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Listed Companies and the New York Stock Exchange

The New York Stock Exchange is a service organization for listed companies, its members, and, most importantly, the investing public.

The Exchange deals with a listed company primarily as a legal entity. Thus, it has no jurisdiction over individual directors. The board of directors of a company, on the other hand, must approve the original listing of the company's securities on the Exchange, as well as any subsequent issuances.

The policies, procedures and requirements of the Exchange as they relate to listed companies are set forth in the **Company Manual.** A copy of the **Manual** is supplied to the Secretary of each listed company and to its outside auditors and legal counsel. Each company enters into a listing agreement with the Exchange in which the company undertakes to follow certain practices necessary to enable the Exchange to provide the best possible market for its securities.

While the formal agreements between the Exchange and listed companies serve as a framework around which a working relationship is built, even more important is the spirit of cooperation they have shown in dealing with matters of mutual concern.

Over the years, this spirit of cooperation has contributed significantly to the confidence the public has placed in the securities of the leading corporations listed on the New York Stock Exchange. The best measure of this confidence is the tremendous growth in shareownership over the past decade. This is a record of which both listed companies and the Exchange may be justifiably proud.

Timely and Adequate Disclosure of Corporate News

A corporation whose stock is listed on the New York Stock Exchange is expected to release quickly to the public any news or information which presumably would materially affect security values or influence investment decisions.

Annual and quarterly earnings, dividend announcements, acquisitions, mergers, stock splits, and major management changes are examples of news that should be given to the financial press and wire services for "immediate release" as promptly and simultaneously as circumstances permit. News of major new products, contract awards, expansion plans, and discoveries very often fall into the same "immediate release" category.

Unfavorable news likely to affect stock values and investment decisions also should be reported promptly, clearly, and in detail. Re-

uctance or unwillingness to release a negative story or an attempt to disguise unfavorable news endangers a management's reputation for integrity and can be damaging to good stockholder relationships.

Few things are more damaging to stockholder relations and the general public's regard for corporate securities than information improperly withheld, whether inadvertently or willfully.

It should be a corporation's primary objective to assure that news will be handled in proper perspective. This necessitates appropriate restraint, good judgment, and careful adherence to the facts. Any projections of financial data, for instance, should be soundly based, appropriately qualified, conservative, and factual. Excessive or misleading conservatism should be avoided.

Premature announcements of new products whose commercial application cannot yet be realistically evaluated should be avoided. So should overly optimistic forecasts, exaggerated claims, and unwarranted promises. And should subsequent developments indicate that performance will not match earlier projections, this too should be reported and explained.

Judgment must be exercised as to the timing of a public release on those corporate developments where the immediate release policy is not involved. In these cases, it is helpful to weigh the interests of both present and potential stockholders who at any given moment may be considering buying or selling the company's stock.

Annual reports, quarterly reports, and publicity releases cannot, by their nature, detail all of the operations of the company. Therefore, it is highly desirable that corporations follow a so-called "open door" policy for the benefit not only of stockholders but also security analysts, financial writers, and others who have a legitimate interest in the various factors affecting a company's business.

A company should not give information to one inquirer which it would not give to another, nor should it reveal information it would not willingly give to the press for publication. By the same token, a company should not withhold information in which stockholders, the investing public, and analysts have a warrantable interest.

To assure that the release of corporate information is handled capably, consistently, and authoritatively, many companies designate one or more key executives to speak for the company in all matters that might affect security values or influence investment decisions. There is much to recommend this procedure.

Normally a director should limit his discussions with outsiders to

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information which is publicly available or which would not be classified as confidential under company policy. However, there may be rare occasions when a director should speak out publicly on some important matter which management should have disclosed.

Handling Confidential Information[1]

Every director, officer, and key employee must exercise extreme care in discussing company affairs with outsiders. This becomes especially important at times when significant confidential corporate deliberations are taking place. The market action of a company's security should be closely watched at these times and the company should be prepared to make a public announcement of the matter under consideration if this becomes necessary. Unusual price fluctuation or trading activity in a security shortly before the announcement of an important corporate development can be extremely embarrassing and damaging. When this happens, the public is quick to assume that someone acted on the basis of "inside" information. Periodic reviews of company disclosure policy and internal security practices can be helpful in preventing these occurrences.

Rumors Affecting the Market

Occasionally, it may be necessary for corporate officials to deny false rumors or clarify misunderstandings which are affecting the market in their company's stock. A quick, clear announcement to the press and wire services along with immediate notice to the Exchange is the most effective procedure under these circumstances.

Stockholder Approval

Stockholder approval obtained through the solicitation of proxies is the essence of corporate democracy. The Exchange has made this a prerequisite for the listing of securities issued in connection with important transactions such as major acquisitions of other companies or businesses, changes in corporate control, stock option plans or acquisitions of property in which insiders have an interest. Where stockholder approval is necessary, SEC proxy rules govern the procedure for obtaining it. These rules require disclosure of information which will permit a stockholder to make an intelligent judgment. The Exchange encourages listed companies to consult shareowners in important matters—even matters beyond those required by law or Exchange policy.

(See also excerpts from **Corporate Directorship Practices**, p. 25)

[1] For directors who are connected with securities firms special problems may arise. See New York Stock Exchange M.F. Educational Circulars No. 152 and 162.

Outside Directors

The election of "outside" directors to the boards of publicly owned companies has become an almost universal practice. The Exchange, in fact, requires that at least two outside directors be on — or added to — the board of each newly listed company. Outside directors provide perspective and objectivity. They can also be especially helpful in guiding and monitoring the company's timely and adequate disclosure practices. More than 97% of the companies listed on the Exchange have at least two outside directors.

The Presidents Association, an affiliate of the American Management Association, has published (exclusively for its members) a number of special studies relating to the board of directors. The following pertinent observations are quoted from these studies by permission:

> "Board members have the stern responsibility of regularly rediscovering a company's state of development and of revising board activity—or board makeup, if need be—to meet the company's changed needs. Success in carrying out this responsibility depends mainly on the objectivity, experience, and independence of the board members. Failure is assured only if the board membership puts personal status and personal aspirations ahead of company needs.
>
> "Lack of objectivity or independence can result in serious misdirection of board activity. This situation is at its worst in an inside board when most members are subordinate to the dominant member—the principal owner or the president. In such cases, members are circumspect about opposing the position of the dominant member. He is the boss outside the board meeting, and they cannot forget this fact inside the board meeting.
>
> "Stated positively, the board gains extensively from the variation in experience and viewpoint which each outsider brings from his world of activity. These gains are cut when there is duplication of experience. Other things being equal, the priority should be assigned in a way which would broaden the board's access to business and community activities."

*(See also excerpts from **Corporate Directorship Practices**, p. 19)*

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Ensuring Ethical Conduct in Business

The possibility of unethical behavior on the part of employees is a matter of continuing concern to a great number of companies.

The December 1964 issue of NICB **Record,** updating a September 1961 article, points to this fact and outlines precautions being taken. It cites the following comments by a corporate executive as a typical reaction:

> "Departure from strict adherence to a code of ethics strikes at the very heart of private, business, community, and national morality and has a real impact on all our futures."

The following excerpts from the original 1961 article are likewise indicative of widely held viewpoints:

> "Directors are said to serve as ethical guideposts for the company.
>
> "For this reason . . . directors as individuals should make certain that their own business relations are conducted on a strictly ethical basis . . .
>
> "Executives with 'built-in principles' serve to assure board members that serious problems in the legal-ethical area will not arise.
>
> "Good management deserves the confidence of the board —bad management should be fired."

(See also excerpts from ***Corporate Directorship Practices,*** *p. 22)*

Conflicts of Interest

Conflicts of interest is usually the major topic of discussion whenever the broad question of ethical business conduct arises. Directors, officers, employees, and the families and close friends of each of these groups all may become involved in these problems. The comments in this booklet are limited primarily to those aspects affecting directors and officers.

A director's fiduciary responsibility to shareholders takes on greater importance in a publicly owned than in a privately owned company. Transactions or relationships which may be entirely appropriate in a closely held company may be totally unacceptable after the public has been invited to participate in the ownership.

A publicly owned company of the size and character appropriate

for listing on the New York Stock Exchange should be able to operate on its own merit and credit standing. It should be free from the suspicion which may arise when business transactions are consummated with insiders.

Attempts are sometimes made to justify continuing conflicts of interest. For example, independent appraisals may be made or the person having the interest may refrain from voting or otherwise participating in the decision-making process. Nevertheless, there remains a delicate question of whether any arrangement would have been made at all if the person with the interest were neither an officer nor a director.

The argument has been advanced that a continuing arrangement with an insider represents a better deal for the company than could be negotiated at arms' length. However, even though an arrangement might have been equitable or favorable when entered into, it may be continued after it has ceased to be favorable. In addition, times change and such arrangements must often be renegotiated before they expire. Whenever these involve insiders, conflicting interests are unavoidably present.

The question of conflicts of interest involves both moral and legal values. This interplay has found its way into court decisions as evidenced by quotes from two well-known cases which follow:

The Supreme Court of Delaware in April 1939[1] said:

> "Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest."

[1] Guth v. Loft, 5 Atl. Rep. 2d 503, 510

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In another context, the U. S. Supreme Court[2] said in 1961:

> "The moral principle upon which the statute is based has its foundation in the Biblical admonition that no man may serve two masters, Matt. 6:24, a maxim which is especially pertinent if one of the masters happens to be economic self-interest . . . The statute is thus directed not only at dishonor, but also at conduct that tempts dishonor. This broad proscription embodies a recognition of the fact that an impairment of impartial judgment can occur in even the most well-meaning men when their personal economic interests are affected by the business they transact on behalf of the United States Government. To this extent, therefore, the statute is more concerned with what might have happened in a given situation than with what actually happened."

Most companies listed on this Exchange have either written or unwritten policies strictly prohibiting any relationship that might be construed as a conflict of interest. In those relatively rare instances where the problem arises, it usually involves companies in the earlier stages of evolution from private to public ownership or those in which a family group still holds a major block of the outstanding stock. The question may also arise in connection with an acquisition or merger where conflicts exist in the other company.

In considering the eligibility of companies for original listing, the Exchange recognizes that each company must be treated on an individual basis. Thus, where a conflict of interest exists that can be resolved promptly, the Exchange expects that it be cleared up prior to listing. In more complicated cases—such as where property is leased and where time may be required to work out complex details—the Exchange requests an agreement that the conflict will be terminated within a reasonable period (usually two to five years).

Once they are listed, companies obviously are expected to conduct their affairs in such a manner as to prevent conflicting interests from arising either in their own operations or in connection with companies they acquire by acquisition or merger. Where unusual circumstances make an isolated "non-arms' length" transaction unavoidable, stockholder approval should be obtained to reduce objections to a minimum.

A list of key matters frequently dealt with in conflict of interest policies is given in the excerpt from **Corporate Directorship Practices** on p. 24 of this booklet. In addition, the cited article an-

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[2] U. S. v. Mississippi Valley Co., 364 U. S. 520, 549

titled "Ensuring Ethical Conduct in Business" in the December 1964 issue of the NICB **Record** reports on the continuing attention being directed to this important topic.

In the experience of the Exchange, conflict of interest problems involving officers and directors (or members of their families) most frequently concern (1) the direct or indirect ownership of property leased to the company; (2) sales or purchases of goods or services to or from organizations in which an officer (or major shareholder) has a material direct or indirect interest; and (3) the ownership by officers or directors of the parent company of a portion of the minority equity in subsidiaries (excepting, of course, directors' qualifying shares or other nominal interests). Generally speaking, relationships of this nature are undesirable.

Director and Officer Stock Ownership

Many stockholders feel that directors and officers should have a meaningful investment in the companies they manage. The extent of this ownership, naturally, would vary in accordance with the financial circumstances of the persons involved. As shareowners themselves, directors are more likely to represent the viewpoint of other shareowners whose interests they are charged with protecting. Similarly, officers—the executive management group—may well perform more effectively with the incentive of stock options or a share in the equity ownership of the corporation.

The Exchange has encouraged the broadening of shareownership through stock option and employee stock purchase plans, especially those plans that include all or a large portion of the company's employees. The approval of stockholders has been a prerequisite of Exchange listing of new shares for the more limited key officer plans.

However, the widespread endorsement of director and officer shareownership brings with it questions that concern the timing of their stock transactions. When may a director or officer properly buy or sell shares of his company's stock? When is it appropriate to award stock options to key executives? There is no simple, uniform answer to these questions, but they do underscore the importance of a policy of adequate and timely disclosure both for the benefit of the investing public and for the protection of management.

Competition requires that companies engage in active programs of research, development, and exploration. For many companies, more than half of today's sales represent new products or services

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invented, discovered, developed, or radically redesigned during the last ten years. Nevertheless, more experimental projects fail than result in salable and profitable products or services. Public disclosure at the earlier stages of new developments may be premature. In addition, competition and the best interests of the company and its shareholders may require a veil of secrecy around new developments before they reach the stage where public disclosure is appropriate. Still, hindsight is remarkably keen and the accusation can always be made that a purchase or sale of stock by a director was dictated by inside knowledge of a future favorable or unfavorable development. **This theory, carried to its extreme, might suggest that a corporate official should never buy or sell stock in the company he represents.**

But to reiterate, stockholders have indicated that they want officers and directors to have a meaningful investment in the companies they manage. So, in the interest of promoting better stockholder relationships, some rule of thumb under which corporate officials may properly buy or sell stock in their company would be helpful. Considerations which may be pertinent in approaching this question are outlined in the paragraphs which follow.

(1) One appropriate method of purchase might be a periodic investment program where the officer or director makes regular purchases under an established program administered by a broker and where the timing of purchases is outside the control of the individual.

(2) It would also seem appropriate for officials to buy or sell stock in their companies for a 30-day period commencing one week after the annual report had been mailed to stockholders and otherwise broadly circulated (provided, of course, that the annual report has adequately covered important corporate developments and that no new major undisclosed developments occur within that period).

(3) Transactions may also be appropriate under the following circumstances, provided that prior to making a purchase or sale an officer or director contact the chief executive officer of the company to find out if there are any important developments pending which need to be made public before an insider could properly participate in the market.

(a) Following a release of quarterly results, which includes adequate comment on new developments during the period. The timing of transactions might be even more appropriate where the report has been mailed to shareowners.

(b) Following the wide dissemination of information on the status of the company and current results. For example, after a proxy statement or prospectus which gives such information in connection with a merger or new financing.

(c) At those times when there is relative stability in the company's operations and the market for its securities. Under these circumstances, timing of transactions may be relatively less important. Of course such periods of relative stability will vary greatly from time to time and will also depend to a large extent on the nature of the industry or the company.

If the size of a purchase or sale is substantial, say more than $30,000 within a 3-month period, the preferable course of action might be to make such a purchase or sale in the time period outlined in (2) above.

Where a development of major importance is expected to reach the appropriate time for announcement within the next few months, transactions by officers and directors should probably be avoided.

Corporate officials should wait until after the release of earnings, dividends, or other important developments has appeared in the press before making a purchase or sale. This permits the news to be widely disseminated and negates the inference that officials had an inside advantage. Similarly, transactions just prior to important press releases should probably be avoided.

In granting stock options to key officers and directors, the same philosophy that relates to purchases and sales may well apply. Where an established pattern or formula is part of a plan specifically approved by shareholders, the question of timing may not arise. In taking up an option, the timing of a purchase is not usually critical as the price is set at the time the option is granted. The reasoning relating to stock options might also apply to employee stock purchase plans in which officers and directors may be entitled to participate.

The considerations that affect officer and director transactions in stock of their own company may be pertinent to transactions in the shares of other companies with whom discussions of acquisition, merger, or important contracts, etc. are being considered or carried on.

The same considerations apply to the families or close associates of officers and directors who are often presumed to have pref-

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erential access to information. As far as the public is concerned, these also are insiders. And while this assumption may be unjustified in many cases, it is a fact of life which those in positions of leadership and responsibility cannot ignore.

Some companies have adopted policies for the guidance of their personnel relating to transactions in the company's stock, as well as other areas where conflicts of interest could arise. Such policies can be very helpful to employees who have access to important confidential information, as well as to the officers and directors.

In the final analysis, directors and officers must be guided by a sense of fairness to all segments of the investing public.

Within the framework of any policies adopted by his company, the final decision of each officer and director with respect to securities transactions must be his own. Each case must ultimately stand or fall on its own merits. No single rule could possibly cover all situations; nor should unnecessary restrictions be permitted to discourage shareownership among these business leaders who play such a vital role in the success of our system of free enterprise.

(See also excerpts from **Corporate Directorship Practices**, *pp. 40-47.)*

Particular attention is directed to the comments therein relating to Sections 10b and 16 of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission.

Where and How Improvements May Be Made

The free enterprise system demands corporate directors and officers of great ability and unquestioned integrity. For many years New York Stock Exchange listed companies (with rare exceptions) have taken great pains to ensure that effective and responsible corporate conduct are watchwords within their organizations.

Excellence is never achieved through complacency, and change is ever with us. The suggestions that follow may serve either as a checklist of present performance or as a guide for future improvements.

A. Corporate Statesmanship.

Statesmanship should mark the conduct of the corporate director. While responsible to the shareholders to make an honest profit, the board of directors and the company must maintain in delicate balance the appropriate interests of employees, customers, public, and country.

B. The Director's Role—An Active or Passive One?

A director must fully understand the extent of his power to act. He must take an active part in corporate affairs. He should insist that board meetings be held regularly. Directors may delegate much of the board's power and authority to executive management and may even require that policy planning and recommendations originate at the management level. However, directors and the board alone have responsibility for major policy and basic objectives and for the selection and election of top executive management. Directors must embrace this role vigorously. They cannot and should not abdicate to management their ultimate responsibility to stockholders. On this point a passive director contributes little of value. Some directors acquaint themselves with the company's non-director officers. In this way, they are better able to appraise the caliber and promise of future management material and vote more effectively when the election of executive management is before the board.

The operation of the company is usually entrusted to the executive management group. Directors, therefore, should avoid involvement in day-to-day details. However, they must provide for a continuous check on management performance. Otherwise the advantages of the checks and balances provided by an effective board may be dissipated.

The practice of having independent accountants appear before the board and report on their audit is to be recommended.

The preparation of the annual report to stockholders is usually handled by executive management, and board of directors' review should not be allowed to delay the preliminary release of the year's results or the prompt mailing of the report itself. However, the board should establish a policy guide for management as to the overall content to be certain that the corporate story will be told clearly, accurately, and adequately without excesses of any kind. Subtle evasions or deceptions should be especially guarded against. Where changes are made in reporting practices which have a material effect on earnings or financial position, directors should make certain that opportunistic alternatives are not being adopted.

C. Balanced Boards.

A director must always observe the highest standards of loyalty to his corporation and its owners. He should represent all shareholders. Two vital ingredients of any board's deliberations are perspec-

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tive and objectivity, and these can be greatly enhanced by the presence of capable and truly independent "outside" directors. The Exchange hopes that the few listed companies who have no such outside representation will seek to eliminate these situations where boards are composed exclusively of employee officers.

D. Youth vs. Age.

To perform their duties properly, directors must have physical and intellectual vigor. Many elderly directors make more effective contributions to their companies than those who are considerably younger; others appear to be retained without reference to their current performance. Corporations might well consider how they can improve their boards and provide for future strength by a better representation of younger directors. Some corporations have come to grips with this problem by initiating retirement age limits for board members or creating special honorary classes of board membership.

E. Disclosure vs. Silence.

As the base of shareownership broadens across the country and as owner-managers are more and more replaced by professional management, the gap between corporate owners and managers sometimes tends to widen. In many cases, the board of directors can effectively bridge this gap, thereby performing a communications function which is essential to corporate democracy.

Complete candor is the vital ingredient in any company-shareholder relationship and shareholders should be quickly given the full details of significant corporate developments. Directors must insist that an appropriate disclosure policy be maintained. It is generally preferable to release too many details rather than too few.

F. Consulting the Shareowner.

Legally, directors have authority to act on a great many matters without referring them to shareowners for approval. These days however, many directors feel that solicitation of shareowner views via the proxy route is a desirable procedure where matters of unusual importance are involved. The Exchange believes that an extension of this philosophy would make a valuable contribution to the cause of true corporate democracy.