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SEC Fines Director for Failing to Disclose Close Friendship with Senior Executive

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In a novel enforcement action, the US Securities and Exchange Commission (SEC) charged a member of the board of directors of a New-York-Stock-Exchange (NYSE)-listed manufacturer of personal and household products for violating the proxy disclosure rules. According to the SEC, the director stood for election as an "independent" director when he did not qualify as independent due to an undisclosed close friendship with one of the company's high-ranking executives. The director was personally fined $175,000 and barred from serving as an officer or director of a publicly traded company for five years.

This case serves as a reminder of one of the primary roles of directors in a publicly traded company: to oversee and monitor senior management on behalf of the stockholders who elect them. This case also highlights the fact that director independence is highly dependent on facts and circumstances and, although public company boards are required by stock exchange rules to assess board member independence annually, the burden is on the individual board member to disclose to the board (so that the board can make its independence determination) relationships with senior management that impair independence.

In this case, the SEC found that the director not only failed to disclose his personal friendship with the executive, but actively sought to conceal it from the company's Board of Directors in a breach of the director's duty of candor under the company's Code of Conduct. Such breach, in the context of the company's annual proxy statement disclosure exercise, violated Section 14(a) of the Securities Exchange Act of 1934.

In Depth

BACKGROUND

According to the allegations in the complaint, the individual charged by the SEC was an experienced public company director. After serving as the CEO of the company for 11 years, he served as the non-executive chairman of its Board for four years. He also served as an independent director of two other public companies during the period in question.

In 2019, the Board made the determination that after the required "cooling off" period from his former executive days had transpired (the director retired as CEO in 2015), nothing precluded him from being classified as an "independent" director since he did not otherwise have a material relationship with the company or its senior management team. As a result, the director stood for reelection at the annual stockholders' meetings from 2019 to 2023 and was described as an "independent" director candidate.

However, according to the SEC, the director had a close personal relationship with the executive since 2017. The director and the executive, along with their spouses, regularly vacationed together – both domestically and internationally – from 2020 to 2023, including six trips that spanned eight countries across five continents. During these trips, the director paid for the executive's first-class airfare and lodging. In all, during the relevant period, the director spent more than $100,000 on travel and vacations for the executive and his spouse. The director did not disclose this relationship to the Board and advised the executive not to tell anyone at the company about their close friendship.

In addition to the travel, the director also shared with the executive, in violation of his duty of confidentiality, information about a sensitive CEO search process being conducted by the Board, which included the executive's potential candidacy.

TAKEAWAYS

The public company governance ecosystem relies on the independence of board members. With certain exceptions, stock exchange rules mandate that public company boards be comprised of a majority of independent directors and major standing board committees (audit, compensation, and nominating/governance) be independent. These stock exchange governance requirements are meant to instill confidence in the investing public that management teams are overseen by board members who, in addition to complying with state law fiduciary duties, avoid relationships with management that could impair their objectivity.

The SEC action highlights the importance of evaluating independence from multiple perspectives. Under the NYSE rules, no director qualifies as "independent" unless the board of directors *affirmatively determines* that the director has no material relationship with the listed company. In the words of the NYSE Listed Company Manual, "it is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company." The overriding concern, however, is independence *from management*. Any relationship between a director and a member of senior management could potentially impair a board member's impartiality and independence.

The NYSE Listed Company Manual provides some guidance on the types of relationships that should be considered. For example, “material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others.” Notably, “friendship” is not called out expressly in the nonexclusive list. And most company “director and officer questionnaires,” which effectively function as the front line of defense in the annual board exercise to determine board member independence, track the NYSE commentary on this point.

In the aftermath of the enforcement action, boards should consider revising their questionnaires to inquire about meaningfully close personal relationships between directors and senior management. Even once a company solicits the information needed to evaluate disclosure decisions, the SEC action raises difficult line-drawing questions. For instance, would a strong mentoring relationship between a board member and an executive impair independence? Similarly, it is not unusual for directors and executives to maintain some form of social relationship outside the company. Perhaps the SEC’s action will be limited to its facts, particularly given the alleged extensive effort of the director to conceal the relationship. A different fact pattern very well could produce a different outcome.

The other significant takeaway is the SEC’s decision to pursue an action against the director personally, rather than the issuer, for misleading proxy disclosure. That decision could have been made for any number of reasons (including the active concealment of the relationship by the director), but it signals the SEC’s willingness to pursue, penalize, and bar individual board members. Directors should take note of the SEC’s aggressive posture, and public companies should be wary of future cases that might charge the public company alongside or in place of the director. The SEC has been aggressively pursuing public companies for internal control failures to identify information required for public disclosures.

More philosophically, this case also reflects the SEC’s willingness to recast stock exchange corporate governance principles as federal securities law disclosure claims.

While individual directors digest this recent SEC enforcement action, it might be prudent for public company legal departments to consider all aspects of the annual board independence process, including the questionnaire forms used, to better assist boards in discharging this important annual duty.

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