SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Office of the Chairman

May 11, 1976

William Batten
New York Stock Exchange, Inc.
11 Wall Street
New York, N. Y. 10005

Dear Mil:

I want to take this opportunity to congratulate you again on your recent appointment and to wish you the best of luck. The job is a challenging one, but one I know you will fill with distinction. I speak for all the members of the Commission in saying that we look forward to working with you on the many complex problems facing the securities industry today. In that vein, I would like to advise you of a subject which Jim Needham and I have discussed informally in the past, and ask for the benefit of your thoughts.

As you know, the Commission has for many years advocated that publicly-held companies create audit committees, composed of independent directors, to work with outside auditors. [Footnote: In 1940, following the McKesson-Robbins investigation, the Commission urged the formation of audit committees, composed of non-officer directors, to participate in arranging corporate audits. In 1972, the Commission endorsed the establishment of audit committees composed of outside directors for all publicly-held companies to provide more effective communications between independent accountants and outside directors, and thereby to safeguard further the integrity of corporate financial statements on which public investors rely. In 1974, in amending its rules to require disclosure in proxy statements of the existence or absence of audit committees, the Commission reiterated its support.] In our review of corporations who have revealed questionable foreign and domestic payments we have found an almost universal use of misleading financial records to conceal such corporate practices from outside auditors and directors and corporate counsel. The existence of an audit committee that meets privately with the outside auditors to discuss the scope of the audit, questions arising during the audit, including disputes with management, and that has access to the corporate financial information, is an important part of our effort to maintain the credibility of our system of corporate self regulation.

I am sure you are aware of the fact that the Auditing Standards Executive Committee of the A.I.C.P.A. has circulated an exposure draft of a new auditing standard which, if adopted, would require auditors to bring any questionable payments that they may find to

the attention of a level of management high enough for corrective steps to be taken. If questionable payments by top management are discovered, such an approach will, of course, be enhanced if an audit committee is in existence.

Additionally, there has been considerable recent comment about steps that can be taken to make the role of the board of directors more meaningful. Some major corporations have already taken steps to restructure their boards so that a majority consists of outside directors, indeed, the Chairman of Connecticut General has recently written us about actions taken by that corporation to create a board consisting only of outside directors and the chief executive officer. While we have no firm notion about the optimum relationship between outside and inside directors, we do believe it is a subject of considerable importance.

Finally, many thoughtful commentators and many major law firms have come to the conclusion that the effectiveness of the board of directors and independent counsel is enhanced when the critical aspects of the two functions are kept separate. This, of course, raises the question of whether members of law firms which have the responsibility of advising the corporation, including the board, should also serve as members of that board of directors.

The importance of maintaining the truly independent character of the boards of directors of our larger corporations has been illustrated by the Commission's recent enforcement actions in the area of questionable or illegal corporate payments. Significantly, in some of these cases no audit committee existed. In the others, with a single exception, audit committees were either only operated during a portion of the time when the questionable payments were alleged to have been made, or not wholly independent of management. Accordingly, the resolution of these actions typically has involved the establishment of a committee comprised of independent members of the board of directors in order to conduct a full investigation, utilizing independent legal counsel and outside auditors to conduct the necessary detailed inquiries. The thoroughness and vigor with which these committees have conducted their investigations demonstrates the importance of establishing entirely independent audit committees as permanent, rather than extraordinary, corporate organs and encouraging the Board to rely on independent counsel.

With these thoughts in mind, we have been considering various approaches to increase the likelihood that larger public corporations will establish audit committees composed of outside directors, that they will take further steps to make the role of the board of directors more meaningful, and that corporate boards will deal with independent counsel. One particularly promising approach to accomplish these goals would be for the Exchange to amend its policies and practices. As the Company Manual points out, the Exchange's listing agreement constitutes a code of performance to which companies commit when listing their securities on the Exchange. When the listing agreement was first instituted in 1899, the Exchange took the lead in the field of financial disclosure by requiring regular financial reports from listed companies; subsequently, independent public accountants were required.

The Exchange's listing policies have expanded in scope over the years. Specifically, the Exchange has long urged the desirability of including outside directors on corporate boards and specifically charging them with ensuring full disclosure of corporate affairs. In its 1973 White Paper on financial reporting, the Exchange recommended that audit committees, preferably comprised exclusively of outside directors, be formed. This recommendation represented a reaffirmation of a principle first raised by the Exchange in 1940.

In keeping with this tradition, the Exchange now could take the lead in this area by appropriately revising its listing policies, thus providing a practical means of effecting these important objectives without increasing direct government regulation. The objectives are sound in principle and, if implemented, they would significantly advance the public interest.

We would very much appreciate receiving your views on whether the New York Stock Exchange would find it appropriate to alter its listing policies along the lines discussed above, We are sensitive to the fact that, to the extent the Exchange's listing policies impose burdens which corporations might otherwise avoid, the attractiveness of listing on the Exchange may be diminished. But, at the same time, the Exchange has frequently recognized that it could provide effective leadership where its initiatives were consistent with developments in public policy in the fields of corporation finance, management, stockholder relations and accounting, and recent surveys suggest that perhaps two-thirds of NYSE listed companies already have independent audit committees.

We look forward to receiving the benefit of your views, particularly as to what Commission action, if any, in this area would be useful. We would be pleased to meet with you to discuss these matters further.

Sincerely,
Roderick M. Hills
Chairman