

The New York Stock Exchange

Chairman Roderick M. Hills
Securities Exchange Commission
500 North Capitol Street, N.W.
Washington, D. C. 20549

August 3, 1976

Dear Rod:

We have discussed your letter of May 11, 1976 and your various suggestions regarding boards of directors of publicly-held companies and particularly the creation of Audit Committees composed of Independent Directors of such companies.

Recently I furnished to you a report of a corporate policy survey conducted by the Exchange of 150 companies, 50 of which were selected from each of three groupings of 500 companies ranked in order by the number of shareholders of records. The top group (Cell A) contained the 500 companies with the largest number of shareholders of record, the middle group (Cell B) the 500 companies ranked 501 through 1,000, and the lowest group (Cell C) the 500 companies with the fewest shareholders of record. The results of the survey may be summarized as follows:

1. The top companies (Cell A) have more board members and a greater proportion of outside directors relative to the other sample company groups.
2. More than four out of five large companies (Cell A) consider a majority of outside directors the optimum proportion on their board as against only three of five among medium-sized (Cell B) and an even split among smaller companies (Cell C).
3. Very few companies, regardless of size, actually provide their board of directors or its committees with the services of independent counsel.
4. Most companies oppose the idea of independent counsel or have no policy or opinion on the subject.
5. Seven out of ten top companies (Cell A) have an independent audit committee consisting of at least three outside directors, while only two of five small companies (Cell C), have one.
6. Almost one-quarter of the companies in the survey, made up mostly of medium and small-sized companies (Cells B and C) do not have any kind of audit committee.

7. More than four out of five large companies (Cell A) have their audit committee findings reported directly to the board, while only around half of the companies in the other two groups do.

The report on the survey contains its detailed findings which reflect varying views on the different issues raised in your letter of May 11, 1976. We have focused our attention on the subject of Audit Committees, and their composition. In that connection we have further analyzed the information received during the survey as shown on the enclosed schedules. Schedule A shows the detailed composition of 81 companies who have Audit Committees with three or more Outside Directors, Schedule B shows the composition of 35 companies who have Audit Committees that have less than three Outside Directors and Schedule C shows the size and composition of Board of Directors of 34 companies in the survey who do not have Audit Committees although a majority of these companies have at least two Outside Directors. Considering this information as representative of our listed companies I have attempted to fashion for your consideration and comment an Audit Committee which would better assure the integrity of a company's financial statement by utilizing on the Committee the knowledge and experience of Directors who although independent of judgment may not be considered an Outside Director by some definition. In wrestling with the problem of definitions I find it more difficult to define the term "Independent Director" than it is to describe the term "Outside Director." I believe therefore that perhaps the term Outside Director describes but one class of Independent Director and not a limitation on its meaning. Attached you will find a draft of a proposal for Audit Committees which would:

1. Require the establishment of an audit committee consisting of a minimum of three Independent Directors.
2. Require that at least two of the directors of a three man audit committee be qualified as Outside Directors.
3. Permit but not require a Board of Directors to exercise its discretion in appointing a highly qualified former officer, who is a director of the company, to its audit committee,
4. Permit the Board of Directors to appoint an audit committee of more than three directors providing that a majority qualify as Outside Directors.
5. Based on our survey, permit listed companies to comply at a reasonably early effective date, after approval of the policy by self-regulatory and regulatory bodies. There would be no need to vary dates by which companies of various sizes must comply, but all companies would have sufficient lead time by which they must be in compliance.
6. Provide a measurable standard by which the policy could be administered by the Stock List Department.

After receiving your comments and making such modifications as may be appropriate, I would propose that we expose draft language to each of our listed companies for their

views. Following that procedure and with the benefit of such comments as we receive, the matter would be submitted to our Board of Directors for their consideration and deliberation as to whether the policy should be adopted as an absolute listing and continued listing requirement. One of the considerations in that deliberation will necessarily be the potential enlarged liability of the Exchange with respect to the performance and functioning of Audit Committees of listed companies. I believe that the limit of that exposure must be reduced to a minimum.

I look forward to receiving your comments. In addition I also wish to confirm my invitation to you to speak to the Board of Directors at the luncheon which precedes our September 2 meeting. The luncheon is at 12:30, but I would be delighted to have you visit with me prior to that time.

Sincerely,
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Enclosures

PROPOSAL FOR AUDIT COMMITTEES

Audit Committee of Independent Directors

Each company as a condition of listing and continued listing of its securities on the Exchange, shall provide in its by-laws or by appropriate resolution of its Board of Directors a requirement for the establishment of an Audit Committee consisting of a minimum of three independent Directors, no one of whom shall be an officer or an employee of the company and at least two of whom shall qualify within the meaning of the term "Outside Director" as herein described.

The Audit Committee may in the discretion of the Board of Directors consist of more than three Independent Directors, but in no event shall the majority of such directors consist of other than "Outside Directors" within the meaning of the term.

Meaning of Terms

Independent Director - The term "Independent Director" shall include those who qualify as "Outside Directors" but may also include a former officer of the corporation who although receiving pension or other deferred compensation payments from the company is in the opinion of the Board of Directors a person who will exercise independent judgment and whose presence on the Audit Committee will materially aid and assist the function of the committee.

Outside Director - The term "Outside Director", with respect to an Audit Committee shall be persons who are not officers, or relatives thereof, employees, former officers, consultants, or persons who are not otherwise compensated on a regular basis by the company other than by directors' fees.

The following are examples of persons who would not qualify as Outside Directors for purposes of an Audit Committee:

Outside Legal Counsel to the Company;

Anyone who would be or represent a controlling person under the SEC definition;

Anyone who would be an “associate” of an officer or controlling person under SEC definition.