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THE HOLDING COMPANY ACT
AS A VITAL REGULATORY MECHANISM

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I am pleased to be here today and to discuss with you some recent developments in the regulation of public utilities by the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935.

As you undoubtedly know, this is a specialized statute that regulates holding companies which have as subsidiaries electric utilities engaged in the generation, transmission and distribution of electric energy, and gas utilities engaged in the distribution of gas at retail. Unless exempt by rule or order under Section 3(a), a holding company must register under the Act. Once registered, a holding company and all its subsidiaries, including nonutility subsidiaries, are subject to prescribed standards with respect to financing; the type and amount of securities that may be issued; capital structure and debt-equity ratios; and the acquisition and disposition of securities or properties, mergers and affiliations.

The central provisions are contained in Section 11(b) which caused much debate and controversy when the bill was considered by the House and the Senate. Subparagraph (b)(1) of that section provides for the geographic integration of registered holding-company systems. In general, each system is to be limited to a single integrated public-utility system which may be either gas or electric, but not both. The holding company may also retain other businesses that are incidental to the operations of the public-utility company. Subparagraph (b)(2) is directed against undue pyramiding of holding companies. It requires the dissolution of unnecessary holding companies and prescribes standards for simplifying the corporate structure of the companies in the remaining system.

The program of geographic integration and corporate simplification has been substantially completed; yet, Section 11(b) still retains its central importance. Under the 1935 Act, the Commission has a variety of other regulatory responsibilities, some of which I have already alluded to. One of the main objectives of these responsibilities is to prevent the recreation of the abuses and evils that had to be remedied and undone under Section 11(b). In the area of regulation, therefore, the past is definitely not prologue.

As of the close of the fiscal year 1972, there were 23 registered holding company systems, of which 17 have been designated as "active" systems; three others are subholding companies; and three are inactive. The 17 active systems had aggregate assets, less valuation reserves, of about $25.7 billion. As they account for about 18 to 20 percent of the electric and gas industry, it is obvious that we are talking about a substantial segment of these industries.

Public-utility systems subject to the 1935 Act have not been immune from the strains and stresses which electric and gas utilities have experienced generally. I have in mind, among other things, the tightening of credit in the

late 1960's, marked by rising interest rates, the decline in coverage of fixed interest charges and in price-earnings ratios for utility common stocks, and the growing demands for capital to meet the necessary expansion of facilities. Overhanging all of these concerns, of course, is the energy crisis and its portents for the future. The 1935 Act provides no shield against these critical developments. It is, rather, a mandate for an effective response within the limits of the authority it grants the Commission to exercise. So conceived, the function of the Commission is to combine innovation and restraint in the administration of the 1935 Act. We try to say yes when we reasonably may, but no when we must.

For the next several minutes, I would like to focus on a few illustrations of this manner and style of approach in the context of some recent developments under the 1935 Act.

The Commission's policy on refundability of corporate debt provides a good first area for discussion. In 1956, we adopted statements of policy regarding first mortgage bonds and preferred stock subject to the Act. These statements prescribe that bonds and preferred stock shall be subject to "redemption at any time upon reasonable notice and with reasonable redemption premiums, if any." Full redeemability was adopted as a basic policy in order to permit refunding when the cost of money declined. This administrative determination was in accord with the legislative policy declared in Section 1(b)(5) of the Act that the public interest and the interest of investors and consumers were adversely affected by a "lack of economies in the raising of capital."

For over ten years, the policy adopted by the Commission worked well, although exceptions were granted in particular and unusual circumstances. In 1968, however, when interest and preferred dividend rates were increasing and credit was tight, some dissenting voices were heard. The protagonists for change claimed that rigid adherence to the policy of free-refundability was increasing interest and dividend costs. Others equally well-informed urged that the 1956 policy was in the best interest of issuers in the long run and should remain in effect.

After published notice, the Commission fully considered both schools of thought and modified its policy so as to permit issuers to suspend the call privilege for a period of up to five years from the date of issuance. In view of the extremely tight money market conditions and the increasing uncertainties in the general business outlook at that time, it was concluded that utilities subject to the 1935 Act should be permitted to take advantage of whatever benefits may be afforded them by offering investors refunding restrictions for no more than five years. The change for bonds was adopted in May 1969 and for preferred stock in June 1970. The changes, however, were not permitted to apply in the case of redemptions upon voluntary liquidiation, or redemptions in connection with mergers, sales of properties or for other nonrefunding corporate purposes. The so-called five-year freeze precludes only refunding by the sale of debt or other preferred stock solely in order to take advantage of lower interest or dividend costs. The Commission declined to follow the majority of

the Federal Power Commission which, in the Consumer Power case decided in 1967, had stated that the five-year restriction on refundability should be left to management's discretion. In its public announcement, the SEC stressed that its policy on refundability will remain subject to continuous review, and that the modifications adopted in 1969 and 1970 may be rescinded or otherwise altered as circumstances require.

A second example of this combination of innovation and restraint by the Commission in administering the provisions of the 1935 Act can be found in the agency's approach to the utilization of commercial paper by public utilities.

Public-utility companies up until the mid-sixties had relied almost exclusively on commercial banks for the financing of their short-term needs. But in the 1960's, the expanding needs of public utilities and of many other corporate borrowers for short-term credit apparently called for suitable alternatives. For the most part, the obstacle to the use of commercial paper of sufficient magnitude to make it worthwhile was a legal problem. The question was whether the sale through a commercial paper dealer is a "public offering" and, thus, subject to registration under the Securities Act of 1933. Under Section 6(b) of the 1935 Act, the Commission can authorize the issue and sale of notes of not more than nine months' maturity but only if, among other things, the issue and sale of such notes is not part of a public offering.

After appropriate study of the matter, we concluded that a public offering would not be involved as long as the following conditions were met: the offering would be limited to no more than 100 persons -- later increased to 200 -- who would be specified by the dealer on a nonpublic list; the notes would not be prepayable prior to maturity; and, if desired by a purchaser, the dealer may repurchase the commercial paper for resale to others on the customer list. These limits, we felt, would conform to our conception of the private offering and at the same time prevent the development of a "secondary market" in this kind of commercial paper.

Furtheremore, since the dealer would purchase the commercial paper for resale to his customers, the offering, unless exempted by order, would normally be subject to the competitive bidding requirements of Rule 50. In each case, therefore, the Commission has granted an exemption since rates for prime commercial paper are not negotiated but are determined in an established market, and prevailing rates are published daily in financial media.

For public utilities under the 1935 Act, we have also been obliged to give weight to the statutory policy of economies in the cost of money. To that end, we have required that authorizations under Section 6(b) would be appropriate provided the effective rate or cost for commercial paper would not exceed the prime rate or cost of bank borrowings of like maturity. Generally, the comparable commercial paper rate tags behind the prime bank rate by a slight margin. Even when the two rates are equal, however, the effective cost of a bank loan will exceed the cost of commercial paper because of the so-called "compensating balance" that the lending bank usually requires from borrowers,

including prime customers. Financing through commercial paper avoids the necessity of maintaining these balances.

I should add that financing by the sale of commercial paper and by bank borrowings are not mutually exclusive. They are complementary sources of credit. In the more typical case, the proposal submitted to us combines both, specifying a maximum for the aggregate of bank loans and commercial paper. This gives the issuing company the desired flexibility in terms of comparative costs and availability of credit. During the last 12 months, we have authorized over $2 billion of short-term debt, of which about 75 percent can be in commercial paper.

The authorizations we have granted are not, of course, without safeguards designed to protect the financial integrity of the public-utility company. Accommodations to financial necessity must be tempered with due regard for the liquidity position of the company. Our authorizations, therefore, are generally made in light of specific representations regarding the ultimate retirement of these short-term obligations after allowing for some intermediate and reasonable period for refunding maturing obligations by the sale of other short-term debt.

In addition, under our statement of policy, which I have already mentioned, a public utility subject to the 1935 Act is prohibited from incurring such unsecured short-term debt in excess of 10 percent of the issuer's secured debt and equity capital, except by consent of its preferred stockholders. While the Commission, in accordance with its statement of policy, has permitted issuers to canvass their preferred stockholders for permission to exceed the 10 percent limit, such authorizations are conditioned on the additional debt being outstanding for a limited period of time and not exceeding 20 percent of such other capitalization. A day of reckoning is ultimately reached, and these short-term debts eventually have to be retired by cash generated internally or with funds obtained by the sale of long-term debt or preferred and common stock. Authorizations of an unlimited period for issuing and reissuing short-term debt would not be sound administration and are surely not a substitute for meeting capital needs through permanent financing.

Another recent development worthy of notice, which is illustrative of the SEC's approach to 1935 Act problems, is that relating to lease financing of utility equipment such as turbines, generators, nuclear fuel assemblies and facilities for liquefied natural gas. Leasing, while not unknown prior to 1935, usually involved a transfer to the lessee of all physical properties as well as responsibility for service. Such leases, however, have been eliminated for registered holding-company systems in the course of the administration of Section 11 by sale, merger or in some other way. Leases that have currently come before us are limited to a particular piece of equipment. They are designed as a means of financing the acquisition of such equipment by utility companies, with the lessors, which are financial or leasing companies, taking and retaining title.

The statutory questions which have arisen to date do not relate to the utility companies, the lessees, since in the leases that have come before us these companies have not been subject to our jurisdiction under the 1935 Act.

The application of the Act has related thus far to the status of the lessor and the beneficial owners under the lease. Sections 2(a)(3) and 2(a)(4) of the Act define an electric or gas utility company as a company which owns or operates facilities used in utility operations. Accordingly, since the financial institution or leasing company has an ownership interest in the facilities, each is considered a public-utility company and the parent of each is deemed to be a holding company under the Act.

To some, this may appear as a sort of statutory quirk that often delights the lawyers but perhaps not their clients. To be sure, during the process of manufacture, the lease and financing arrangements relate only to the piece of equipment itself. But when delivered and installed in place, that equipment becomes an integral part of a utility unit or facility and, as such, vital and essential to the operations of the public-utility company. In this functional posture, the lessor and the beneficial owners can no longer be regarded as mere title holders or institutional suppliers of capital.

Sections 2(a)(3) and 2(a)(4) provide for exemptions under specified conditions and we have granted such exemptions in 11 cases; but more exemption applications have been filed and are pending. The case-by-case process has been slow and unwieldy, and variations in the forms of lease financing have given rise to intricate problems in interpreting the specific statutory exemptions. Accordingly, on January 9, 1973, we published for comment a proposed rule under which institutional lessors and beneficial owners would be excluded from the definition of "owners" of utility facilities in Sections 2(a)(3) and 2(a)(4) if certain conditions are met. I shall not dwell upon this proposed rule. It has been published and widely distributed for comment. I would, however, call attention to that condition which requires the terms of the lease to have been approved expressly "by the regulatory authority having jurisdiction over rates and service" of the utility company that is leasing the equipment.

This brings me to my final subject, namely, the holding-company conglomerate. In my discussion of this area, I will be referring to the one-utility holding company, which has one subsidiary engaged in the electric or gas utility business and proposes to engage, or is engaged, directly or through other subsidiaries, in non-utility businesses that are unrelated to its utility operations.

The holding-company conglomerate is really not a new phenomenon. It predates the passage of the 1935 Act. In years prior to the Act, many holding companies, in addition to acquiring and consolidating control over electric and gas utility companies, acquired also a host of nonutility companies engaged in telephone, ice and water, mining, real estate and many other businesses. These ventures in diversification were of substantial concern to the Congress and justifiably so.

As was evident at that time and in succeeding years as well, when a public utility indulges in outside ventures unrelated to the utility business, the investment caliber of its securities may decline, its costs of capital may rise and the rates which support the securities frequently become higher than might otherwise be necessary. The consumer interests may also suffer if the

management must divide its attention between the utility business and unrelated speculative ventures. Historically, I might add, those holding-company systems whose interests were the most diversified experienced the greatest difficulty in meeting interest payments on their various debt securities and were often the ones which defaulted on their preferred dividends and ultimately caused huge losses to their investors.

In view of many of these considerations, the Congress declared, in Section 1(b)(4) of the 1935 Act, that the public interest and the interest of investors and consumers are adversely affected "when the growth and extension of holding companies bears no relation to . . . the integration and coordination of related operating properties." The substantive and regulatory standards, as I mentioned earlier, are prescribed in Section 11(b)(1) and provide that a registered holding company may retain a geographically integrated public-utility system and "such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations" of its public-utility system.

In its administration of Section 11(b)(1), the Commission has determined that such other businesses, to be retainable, must be functionally related to the public-utility business. This interpretation has been affirmed by the courts, most recently in the Michigan Consolidated case. For example, a gas pipe line or a gas producing subsidiary -- nonutilities under the Act -- may be retained if their primary purpose is to serve and supply the system's distribution business. An office building is so related if it is used principally for the system's personnel; it is not so related when a major part of its space is leased to outside tenants. Sale of appliances is also permitted as a functionally related business. There is no need to go on. These are sufficiently illustrative.

An important issue, from an interpretative standpoint, is whether the exempt holding company should be held to the same functional standards. Section 3(a)(1) authorizes us to exempt from the 1935 Act a holding company whose subsidiary utility operations are predominantly intrastate. But it adds an important qualification. It states that such exemption shall be granted "unless and except" the Commission finds that the exemption would be "detrimental to the public interest or the interest of investors or consumers." Pursuant to this statutory language, should a holding company lose its claim or right to an exemption if it diversified by engaging in business not related to its utility operations? That specific question was presented to us most recently in two cases: National Utilities and Pacific Lighting.

National's subsidiary, Elizabethtown Gas Company, and its predecessors have been engaged for over a century in the retail distribution of gas in New Jersey. In 1969, Elizabethtown's management organized National to facilitate diversification into other businesses which ultimately included a travel agency and an investment in an executive airline service. By an exchange of its stock for the outstanding stock of Elizabethtown, National became a holding company with Elizabethtown as its subsidiary. Pacific Lighting, on the other hand, is an old established holding company which secured an exemptive order in 1936 when it was essentially in the retail distribution of gas in southern California. In

the 1960's, it began a program of diversification which currently includes land development, real estate brokerage and management services, farming and other nonutility business in several states, including Hawaii.

National filed an application requesting an order of exemption under Section 3(a)(1). In the case of Pacific, we initiated a proceeding before us to determine whether its exemption under Section 3(a)(1) should be revoked or modified in view of Pacific's diversification into other ventures. In both cases, in opinions filed on January 11, 1973, the Commission was evenly divided.

In a joint opinion, former Chairman Casey and Commissioner Loomis stated that actual detriment attributed to diversification must be shown in each particular case. If such a showing is not made, the Commission, in their view, should grant an exemption to a holding company which meets the objective standards of Section 3(a)(1) -- intrastate operations. They also set forth certain guidelines for diversification that must be met for the exemption to be granted or continued, and concluded that these guidelines were substantially met in both cases.

In a separate opinion, in which Commissioner Herlong joined, I disagreed with this approach. While I do concur with Messrs. Casey and Loomis that a per se prohibition for exempt holding companies of all nonutility activities is not warranted under the statutory structure, I would not allow activities that are not related or complementary to the utility business. It is my view that such unrelated activities would disperse and dilute the predominant utility orientation that is necessary for proper protection of the statutory interests and would tend to impair the stability associated by investors with public-utility operations. As I stated in my opinion, such unrelated activities are "fraught with the same danger of injury to the public utility investor and consumer interests as the scattered and risk-laden ventures that led to the abuses described in Section 1(b) of the Act, the recurrence of which I view the 'unless and except' clause clearly directs this Commission to prevent." Some of the specific dangers were, as you will recall, mentioned at the outset of this discussion on diversification.

The even division of the Commission does not lead to the same result in both cases. In Pacific, as we instituted the proceeding to determine whether its 1936 exemptive order should be revoked or modified, the even division leaves the 1936 order in effect. In National, as the company applied for an order of exemption, the equally divided Commission leaves the application undisposed of and still pending. National, in the meantime, has the benefit of an interim exemption since we consider its application for exemption as filed in good faith. In view of this division on the Commission, let me emphasize that the issue of permissible diversification by exempt holding companies under the 1935 Act is by no means a closed question. I am sure that such holding companies which have embarked upon diversification programs will do so with this in mind.

In concluding my discussion on this subject, I must refer briefly to the highly informative report on diversification by the Ad Hoc Committee on Non-Utility Investments of the National Association of Regulatory Utility

Commissioners published in August 1972. Several of its recommendations are, in my mind, most relevant. Among the more important would be the emphasis on the necessity of segregating the utility and nonutility activities in the different companies or in different subholding-company systems. When these different types of activities are separated, the Committee would argue that the utility financing function is protected to some degree. It also suggested that regulatory efficacy probably is promoted by such a separation. With this I would agree.

With regard to the nonutility operations which the Committee would recommend be permitted, emphasis is placed on functionally related activities and complementary operations which are not overly large in relation to the utility operation and which are within the utility's financial and managerial resources. As is evident from my opinions in the National and Pacific cases, I have some definite sympathy toward this restrictive approach.

And finally, the report also would permit the utility company to participate in governmentally supported housing projects for low and middle income families. I am personally very pleased with this recommendation. I had so urged in my dissenting opinion in Michigan Consolidated with respect to a registered holding company by way of exemption pursuant to Section 9(c)(3). I would allow the same for an exempt holding company as I have indicated in my separate opinion in Pacific. Commissioner Herlong, however, does not share my view on this point.

In closing, I would just like to stress that we at the Commission are aware of the problems and challenges which you in the industry face. At the same time, you must recognize that we have a mandate from the Congress to protect the interests of the public, the investor and the consumer. In exercising the authority granted by the 1935 Act and in administering its provisions, we have tried and will continue to try to regulate in an enlightened manner.

Hopefully, with cooperation between members of the industry and the Commission, the interests and aims of both sides will be served.

Thank you again for the opportunity to speak to you today.