Appendix

Important addresses on questions of public interest delivered at the Annual Convention of the Section of Public Utility Law of the American Bar Association at Indianapolis, Ind., September 29-October 3, 1941.

Some Current Problems under the Public Utility Holding Company Act

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I WELCOME the opportunity given me to discuss some of our current problems in the administration of the Public Utility Holding Company Act. I propose to confine my remarks primarily to the enforcement of the integration and simplification provisions of § 11 of the act, except in so far as the administration of other provisions of the act are interrelated with the administration of § 11.

During the past year and a half there has been material progress towards achieving the integration and simplification objectives of the act. Perhaps more important, however, is the foundation which has been laid for further accomplishment at a constantly accelerating pace. Today the managements of the leading holding company systems are substantially advised as to the scope of the action which must be taken to bring about compliance with § 11 of the act. And they know that compliance requires a vast transformation of utility holding company systems as they are now constituted. As to some of the holding companies, the commission has already entered orders prescribing the action to be taken; as to others, the proceedings have reached the stage where such orders may be expected in the near future. Moreover, in the course of the proceedings leading to these specific orders, the commission has had occasion to pass on most of the disputed questions of interpretation of the act. These decisions afford a basis for predicting with a fair degree of accuracy the scope of the orders which may reasonably be anticipated even by those holding company systems for which no immediate orders are in prospect. As you know, the statute provides that an order of the commission under § 11 shall be complied with within one year, subject to the power of the commission to grant an additional year for compliance. Thereafter the commission may apply to a court for enforcement of its order. The commission has indicated, however, that it does not consider itself to be under an absolute duty to seek an immediate court order at the expiration of such period where the company concerned is proceeding with diligence and good faith to comply with an order. In view of the progress already made, or in prospect, in prescribing the action required of the various holding company systems, our major administrative concern today relates to the final step in achieving the objectives of the statute; namely, the choice between the various alternative methods available under the act for compliance with the requirements of § 11(b), either as specifically prescribed in an order entered under that section, or as submitted in a voluntary plan filed under § 11(e) of the act.

IN reaching this stage in the administration of the act, there have, of

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course, been differences of opinion as to some of the legal questions involved. But when we look back upon the legislative battle over § 11, upon the bitter legal fight which followed the legislative battle, upon the period of initial reluctance of the industry to effect voluntary changes in anticipation of the enforcement of § 11, and upon the various procedural skirmishes in connection with the proceedings instituted by the commission under § 11(b), the one thing that stands out today is the striking change in the climate of opinion under which we operate and, particularly, in the attitude of the leaders in the industry towards compliance with the integration provisions of the act. Holding company officials, such as Leo Crowley, head of the important Standard Gas and Electric system, believe that the integration program is ". . . a necessary and practical treatment of obvious corporate needs." The president of the United Light and Power system, William G. Woolfolk, recently reported to his stockholders that.

> In the rearrangement of properties by way of compliance with the act, we have noted no indication that the regulatory authorities will be other than helpful in protecting the investor, and out of what must now seem to you a complex and nebulous situation, your management foresees in the reasonably near future the emergence of a company which, though smaller perhaps, will be in every way creditable. To this end we are bearing our every effort.

To many of you who, as counsel for registered holding companies and their subsidiaries, are closely following developments in the administration of the act, this change in attitude, and the reasons for it, will be nothing new. I am assuming, however, that some of you have only occasional contact with the Holding Company Act and its problems, and, for that reason, I shall indulge in a slight diversion on the reasons for the passage of the act, the general scope of its provisions, and the central importance of the integration and simplification provisions in the purpose of the act. As I review this history, it seems to me that the problems and outlook of the industry and the resultant regulatory problems have tended to shift in part with changes in the general economic business picture and have to a large extent reflected changes in the business cycle.

You will all recall how the holding company problems in their most acute form—the most extreme examples of mushroom growth, inflationary practices, and financial complexities—were manifestations of the speculative madness which characterized the latter years of the 1920's. You will also recall the spectacular collapse of some of the holding company systems in the early 1930's, how some of the companies like Middle West Utilities and the superholding companies of the Insull system were forced into bankruptcy, how bankruptcy revealed that most of the assets of these companies had been pledged to secure bank loans, leaving the cupboard extremely bare when it came to satisfying the claims of the public holders of their securities.

A gruesome echo of investors' past experience with scattered holding system control of utility operations was heard only the other day when Federal Judge John Barnes ordered final liquidating payments of the once $238,000,000, but now bankrupt, Insull Utilities Investment, Inc. The final distribution brought total payments in bankruptcy on each $1,000 of debentures to $83.47. Junior security holders, of course, received nothing.

Other holding company systems, although less heavily burdened with debt, nevertheless found themselves unable to pay dividends on their preferred stocks. Dividend arrears which began to accumulate at that time are largely still unpaid and in many instances are still accumulating. Accompanying the bankruptcies and preferred dividend arrearages was a precipitous decline in market values of holding company securities, particularly of the common stock of holding companies. This decline was primarily the result of leverage working in reverse. Slight declines in operating company net income or even mere declines in anticipated rate of growth were

magnified many times in their effect upon the thin equities of holding company common stocks. At the same time, widespread opposition to excessive servicing fees foreshadowed the day when this lucrative source of holding company income would no longer be tolerated.

THE tremendous losses suffered by holding company investors in the early 1930's did much to bring about a widespread realization of the evils which resulted from unregulated holding companies and the consequent need for Federal regulation. Even prior to the depression, however, there had been some suspicion as to the regulatory problems presented by holding companies, and it was on February 17, 1928, in Calvin Coolidge's administration, that the Senate, by resolution, directed the Federal Trade Commission to undertake an investigation "into certain practices and conditions relating to specified classes of public utility corporations and corporations connected therewith."

The monumental study undertaken pursuant to this resolution culminated in the reports on public utility holding companies of the Federal Trade Commission. This was followed by the report of the National Power Policy Committee which briefly outlined recommendations for legislation, and by the President's message of March 12, 1935, transmitting that report to Congress and recommending the enactment of holding company legislation. The theory of the National Power Policy Committee, which was ultimately embodied in the act, was that the holding company problem could be dealt with only by a fundamental reorganization of the industry, substituting regional holding companies, in so far as holding companies might be necessary, with simpler corporate structures. This basic approach is best stated in the following excerpts from the President's message:

> . . . Regulation has small chance of ultimate success against the kind of concentrated wealth and economic power which holding companies have shown the ability to acquire in the utility field. No government effort can be expected to carry out effective, continuous, and intricate regulation of the kind of private empires within the nation which the holding company device has proved capable of creating. . . . It is time to make an effort to reverse that process of the concentration of power which has made most American citizens, once traditionally independent owners of their own businesses, helplessly dependent for their daily bread upon the favor of a very few, who, by devices such as holding companies, have taken for themselves unwarranted economic power. . . .

THE industry itself conceded that the abuses which had developed in connection with holding company systems were such as to require regulation by the Federal government, but opposed the theory that any fundamental reorganization of the industry was required. Their alternative legislation was adapted to the preservation of the creations of the holding company promoters, with provisions designed to prevent repetition of the more extreme promotional extravagances and to eliminate other relatively minor but admitted abuses. The opposition to any provisions undertaking to reverse "the process of concentration of economic power" and to bring about a simplification of holding company systems was stubborn and costly. However, as you know, Congress ultimately concluded that it was both necessary and feasible to undertake this task; and the disputed provisions for integration and corporate simplification, with some modifications, remained as the focal point to which are related all the other provisions of the act. It was of course recognized that the carrying out of this mandate to bring about a fundamental reorganization of the industry would be no easy administrative task.

The commission has now been administering the Holding Company Act for almost six years. It is nearly three and one-half years since the Supreme Court upheld the registration provisions of the act in the historic Electric Bond and Share decision.

During the early period of litigation and even for a time after the Bond and Share decision, the administrative

energies of the commission were largely devoted to the exemption problems affecting the general scope of its jurisdiction, to the building up of a staff, and to acquiring familiarity with the diverse practices and problems of the various registered holding companies and their subsidiaries in relation to the requirements of the act. At the outset, relatively broad exemptions were provided by rule as to classes of transactions which would otherwise require regulation under the standards of §§ 7 an 10; service companies were virtually permitted to "write their own ticket" on an experimental basis, as to methods of organization and allocation of costs subject only to the requirement that the profit element in servicing be eliminated.

Again, many of the statutory powers of the commission, particularly those relating to intercompany loans, dividends, and sales of portfolio securities, and to the dealings between affiliates, remained unexercised for a considerable period of time. In dealing with the many refunding operations which have constituted the principal financial transactions up to now, there was at first a tendency to regard "any improvement of a bad financial structure" as "a step in the right direction" and thus to be tolerated even though the issuers' proposals might "stop short of the point where the resultant financial structure is consistent with sound finance and the objectives of the act." The commission has recently reviewed this policy in the El Paso Electric Company Case and has concluded that refunding issues as well as issues for new money should be tested under the strict standards of financial soundness imposed by § 7(d).

THERE has been a corresponding development in other aspects of our regulatory effort. This development has tended to focus attention upon the fundamental weaknesses of many holding companies. Thus recent decisions in the administration of § 13 have made it impossible for the holding companies, through common officers and employees, to shift to the operating companies the expenses of essentially holding company activities relating to the control of their subsidiaries. There has been increasing pressure for the maintenance of more adequate standards of depreciation. Requirements with respect to competitive bidding in the sale of securities have diminished the stake which the traditional bankers for holding company systems heretofore enjoyed in the maintenance of the status quo.

Paralleling the gradual evolution of regulatory principles there has been a shift in the underlying conditions affecting the industry which has served to exert increasing pressure to correct unsound structures. Thus, the initial period of relatively cautious approach by the commission to the exercise of its regulatory powers over financial transactions happened also to be a period of relatively static conditions in the industry itself. Although there has been a continuing growth in the demand for electricity on the part of customers of the electric utility subsidiaries, there was in the early 1930's a decline in the amount of new construction. Later, as the volume of new construction increased, it was possible to provide for it largely out of the cash resources of the companies concerned, and it was still not necessary to sell an appreciable amount of new securities for this purpose.

IT was generally recognized, however, that the time would come, inevitably, when it would be necessary to raise additional equity money to meet the needs of a still expanding industry. Some realized that this was a serious problem. Very few of the holding companies were in a position to sell equity securities and their control constituted an obstacle to the direct sale to the public of new common stock of their operating subsidiaries. Even where the problem was recognized, however, the industry was not compelled to face it so long as the relatively static conditions continued. Now this static condition of the industry no longer exists. Even prior to the recent expansion of industrial activity accompanying the defense effort, the point had come where

reserve capacities of many operating companies in holding company systems were dangerously low in relation to the power demand. More recently, the actual and potential power shortage in relation to the defense program has become a serious national problem. The result has been constantly increasing pressure upon the industry to get itself in shape to finance new construction, which, of course, means in shape to sell equity securities.

In the meanwhile the commission has made the progress already referred to, in carrying forward proceedings under §§ 11(b)(1) and 11(b)(2) affecting the major holding company systems. I shall not attempt to view these developments in detail as I understand they are within the scope of other papers to be delivered in this meeting.

I wish to point out, however, that as the underlying economic forces gathered momentum, the resulting pressures coincided with progress on the part of the commission in compelling compliance with the integration and simplification provisions of the act.

WE are now on the threshold of the final stage in the accomplishment of the integration and simplification program which Congress has prescribed. This final stage consists of the steps to be taken to comply with the commission's orders under §§ 11(b)(1) and 11(b)(2) —steps which must be without prejudice to any class of investors or consumers and with maximum economy and savings to the holding company system. The commission is required to be as vigilant and alert to protect the public interest and the interests of investors and consumers in the carrying out of its orders under § 11 as it is in all the other regulatory provisions of the act. The commission will not, of course, permit § 11 to become a vehicle for a repetition of the sacrifice of investors' and consumers' interests.

There are many workable methods of complying with the commission's integration orders—methods which, under the cold test of actual experience, have demonstrated their effectiveness. Time and experience have shown that orderly disposition of a holding company's interest in operating companies can be effected not only without disturbance to security markets, but at advantageous prices to the holding company and its investors. We have had successful sales of common stocks of operating companies by holding companies complying with § 11 in the cases of Newport Electric Corporation, Indianapolis Power & Light Company, Washington Gas Light Company, Michigan Public Service Company, Connecticut Light & Power Company, San Diego Gas & Electric Company, and Northern Natural Gas Company.

IN most of these cases, cash received from the sale of securities was used to retire senior securities of the holding company or to strengthen the remaining operating companies in the system. The proceeds of the sale of the Indianapolis Power & Light common stock alone were sufficient to redeem all of the outstanding debenture issue of its holding company, Ogden Corporation, and nearly half of Ogden's preferred stock. The real effect of these essentially refunding transactions is to replace holding company securities with down-to-the-rails operating securities—which gives the investor a more remunerative and a basically sounder security.

In the San Diego Case, exchanges of holding company debentures for operating company common stocks, coupled with a subsequent public sale, were employed very successfully. The capital structure of Standard Gas and Electric Company, the parent of San Diego, was top-heavy with highly disproportionate amounts of debt and other fixed-obligation securities. The holding company proposed and carried out a plan under which their debenture holders were given the privilege of exchanging their securities for common stock of the San Diego Company.

The balance of the stock which was not taken in exchange by the debenture holders was publicly sold through un-

derwriters. This transaction was beneficial to all participating groups; San Diego was freed from the control of a holding company which had nothing to contribute to it and which only burdened it; Standard Gas debenture holders who accepted the exchange offer received an attractive utility common stock with good earning capacity; and Standard Gas complied with the law by disposing of an outlying utility property whose retention was economically unsound.

ANOTHER method of compliance is the exchange or sale of utility securities or utility assets with other holding company systems or with independent operating companies where the transferred property is capable of physical integration with adjacent properties of the acquiring company or system. Multilateral trades of this nature may be feasible in some cases. In other instances, it will be possible to sell a particular nonretainable property to the public or to an adjacent system, and then to use the proceeds to purchase a property disposed of by still another holding company, which can be integrated with the system or systems permitted to be retained. Sales or exchanges of utility properties to neighboring systems are an economical method of compliance with the act, and, properly employed, accomplish the further beneficial purpose of integration and coördination of utility facilities in a given area or region.

We anticipate that when integration orders are outstanding against major holding company systems, sales and exchanges of properties will become a much more prevalent method of meeting the standards of the act. One important caveat should be noted. The acquisition of adjacent properties by a holding company system may be permitted only where it tends to the development of an integrated system, which means that concrete economies must be demonstrated and that the combination of properties must not be so large as to impair the advantages of localized management, efficient operation, and the effectiveness of regulation.

AS I stated before, the commission's objectives in supervising the steps being taken in the carrying out of its orders under § 11 are that measures of compliance must be without undue prejudice to any particular class of security holders or consumers and must be with maximum economy and savings to the holding company system. In a given set of circumstances, some methods of compliance may conserve and enhance values where others will dissipate them. Where it is feasible to arrange exchanges whereby the holding company's security holders receive for their securities, common stocks of operating companies, compliance with the act can be achieved economically. Through these exchange plans, the assets of the holding company, consisting, usually, of the common stocks of the controlled subsidiaries, may be exchanged for the obligations and senior securities of the holding company with little, if any, shrinkage in the conversion process.

Exchange plans—fairly worked out—are beneficial to all classes of security holders of the holding company. The principal assets of a holding company, it must be remembered, are the common stocks of operating companies. Against the common stocks of such operating companies, the typical holding company has issued and sold to the public debentures, preferred stock, and its own common stock. Frequently, the holding company common stock represents only a small proportion of the total capitalization of the holding company, particularly after adjustment is made for write-ups and other inflationary items in the accounts of system companies. From an economic viewpoint, the debentures and preferred stocks of a holding company are somewhat of an anomaly. They rest and are dependent mainly upon common stocks of operating companies, securities with no fixed claim to income. It is only realism, therefore, to recognize that when the holding company senior security holder receives the only assets which his company possesses in exchange for his securities, he is neither being deprived of anything nor being subjected

to discriminatory treatment. Of course, the value of the assets of the holding company given to him in exchange for his securities must bear an equitable relation to the securities he holds. It is at this point that the exchange transaction must be tested for its fairness to security holders.

WHERE there are advantages to be gained from the exchange method it is the common stockholder who, by reason of his marginal position, will be most materially benefited. Indeed, there are situations where the exchange method alone can give the holding company common stockholder a substantial return on the liquidation of his company or leave a substantial residue for him if the holding company is to continue in existence. The holding company common stockholder, therefore, cannot afford not to utilize the exchange method of compliance wherever it is feasible as contrasted with more costly methods.

Exchange plans, moreover, may be much more easily consummated than sales of securities for cash at a time when our capital markets are subject to some strain as a result of the rapid capital expansion flowing from the defense program. Exchange plans obviate the necessity of raising new capital by the sale of holding company common stocks and using the proceeds to pay off people in cash whose retention of their securities evidences no desire to receive cash. Instead of finding themselves in possession of cash which they must reinvest at a time when investment is somewhat difficult, holding company security holders would become persons directly owning operating company securities rather than owning them indirectly through the unnecessary and costly conduit of the holding company.

EXCHANGE plans, of course, do present certain difficulties. They impose upon the commission and investors the burden of valuation of the portfolio common stocks offered in exchange for the senior securities. There is also the problem of determining what particular groups or "baskets" of operating company securities constitute an equitable exchange for the outstanding holding company senior securities. There is the question of whether senior security holders of the holding company should receive in exchange holding company assets valued at their current market prices where such prices reflect abnormal conditions. There is the further problem, which is also present in the case of sales of holding company assets to the public and a subsequent retirement of senior securities of the holding company, as to whether the holding company senior security holder should receive the equivalent of the principal or par amount of his claim or preference, the involuntary liquidation amount, the voluntary liquidation amount, the market price, or some other amount which may, perhaps, be something less than his full priority were a bankruptcy liquidation or Chap. X proceeding involved. The principles governing such exchanges will have to be developed in our traditional case-by-case method in the light of specific factual situations and equities.

All the problems I have mentioned arise from the complex structure of the holding company. In those instances where the parent holding company by recapitalization, or by retirement of senior securities, has reduced itself to an all common stock structure, whatever may remain to be done to limit the scope of the operations of the system, or to eliminate unnecessary holding companies, presents no serious valuation problem. It becomes a simple matter of arithmetic. Portfolio holdings may be distributed as a partial or total liquidating dividend.

IN the case of many holding company systems a comprehensive exchange plan affecting the entire portfolio as presently constituted is out of the question. Many of the operating companies, although inherently capable of functioning as independent units "without the loss of any substantial economies"—in fact with definite savings over the costs imposed by the holding company rela-

tionship—may nevertheless be so overburdened with debt and preferred stocks as to require financial rehabilitation before severance from the holding company system. This financial rehabilitation may well require a substantial increase in equity investment by the parent holding company. Cash for this purpose may be obtained by sale of some of the other assets of the system which are in shape for sale. Again, where the existing holding company is to continue as a vehicle for control over one or more integrated systems, cash may be necessary to strengthen the subsidiaries to be retained and this may most feasibly be raised through sale of certain holdings to be severed from the system. In the course of any such program there will be frequent recourse to the powers of the commission to effect financial simplification under §§ 11(b)(2) and 11(e), both with respect to the holding company and its subsidiaries.

Compliance with the act by a particular holding company system may require, therefore, the use of a combination of methods—sales of securities and properties, exchanges of properties to adjacent systems, exchange of common stocks for senior securities, coupled with simplification of holding company and operating company structures, and, finally, distribution of securities as liquidating dividends.

In view of the substantial advantages of using holding company assets to retire holding company securities through exchange plans over some of the alternative methods of complying with § 11(b), the question arises as to whether the commission should not insist on the use of this method of compliance in the interest of the investors in the holding company, particularly of its common stock investors, if it can be feasibly worked out. Exchange plans dependent upon affirmative voluntary action by senior security holders of the holding company frequently fail to achieve their full goal merely because of apathy, indifference, or lack of knowledge on the part of the senior security holder. But the act, of course, contemplates the possibility of compulsory exchanges pursuant to a fair and equitable plan of reorganization. If a holding company security holder receives in exchange for his security a fair equivalent of its value in the assets of the holding company, he cannot justly complain that he has not received cash. There is no sacred right to cash in corporate reorganizations under Chap. X—indeed, cash is seldom received. Likewise, there should be no inviolate right to cash in the corporate reorganizations required, in the national interest, by the Holding Company Act where conversion of assets into cash unduly prejudices other security holders. Under the antitrust laws, compliance with dissolution decrees conventionally takes the form of a distribution of the assets of the corporation.

The legislative history of § 11 indicates that exchange plans were contemplated by Congress as, perhaps, the favored method of compliance. Proponents of § 11 in the Senate and House pointed out that the use of this method assured investors of the preservation of the full value of their holding company assets. The Senate committee report on the Holding Company Bill, for example, pointed out:

> . . . The title does not require the dumping or forced liquidation of securities. Such disposition as may be necessary can be accomplished by reorganization which will equitably redistribute securities among existing security holders . . . The individual investor in present-day holding companies should come out of any reorganization process under the title with far better securities than those with which he went into it. He should get a security which represents an actual down-to-the-rails investment in a regulated local operating company, or, at most, a regulated regional holding company. He should get a security which will bring him, instead of paper stock dividends, all the legitimate cash dividends the operating company can pay—not what is left of them after high salaries, large fees, bonuses to holding company officers and bankers, and the purchase of securities at exorbitant prices from corporate insiders. In short, the individual investor should receive the kind of a security he thought he was buying in the first place.

Other methods of complying with § 11 have been suggested—some by holding companies themselves. One of these methods—sterilization of voting power by the holding company—has not proved very successful. In the case of H. M. Byllesby & Company the commission found that the transfer of Byllesby's controlling securities in Standard Power and Light Corporation to voting trustees did not result in an actual insulation of control. In the subsequent Cities Service Case, the commission found again that the holding company had not actually divested itself of control.

In cases where the holding company involved has public security holders, sterilization of voting securities of the subsidiary companies has elements of serious unfairness to them. Assuming insulation is effective, such security holders are deprived of the protection which voting power gives to common stockholders. Moreover, these security holders invested in a management company; sterilization converts their company into an investment trust whose assets consist of common stock equities in only one industry. It appears, therefore, that protection of the interests of the existing investors in the holding company would make it difficult to approve the conversion of a utility holding company into a sterile investment trust. In view of the dangers invited by sterilization as a method of meeting compliance with § 11, the commission's staff has viewed it with more than a little skepticism. Other methods of compliance appear to be considerably more desirable.

Many of the issues which I have discussed are still open and unresolved by the commission. I have merely given you some of the thinking current among members of the commission's staff. These issues have been raised here because this meeting is an excellent forum at which to present them for the consideration of the industry and the bar. As enforcement of § 11 progresses, most of these problems will be resolved. Utility investors and consumers and the public will then be in a position to reap the full benefits of the objectives of the Holding Company Act.