ADDRESS

of

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at the

ANNUAL MEETING

of the

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

Held at

WALDORF ASTORIA HOTEL

New York, N. Y.

Thursday, April 29, 1937 - 10 A.M.

41877

SIXTEEN MONTHS OF THE HOLDING COMPANY ACT

It is gratifying to have the opportunity to discuss with representatives of the National Association of Mutual Savings Banks the operation of the Public Utility Holding Company Act of 1935.

In a letter to me dealing with what should be the subject of this address your President quoted the concluding sentence of a talk I made last August. This sentence reads: "Meanwhile both the industry and the Commission are acquiring useful experience in many aspects of our fundamental problem, which is defined by the Act as the protection of the public interest and the interest of investors and consumers." Your President wrote that this sentence suggested thoughts which might well be amplified into an address. So that is why I am to talk about our sixteen months' experience with the Holding Company Act. I have no difficulty in understanding why your President made his suggestion for I am advised that a recently prepared consolidated statement for the eighteen states in which mutual savings banks are located shows that the public utility holdings of these banks amounted to over $610,000,000 and constituted 5.32 per cent of the total mutual savings bank resources which were said to aggregate over $11,400,000,000.

The fundamental purpose of the Act is the protection of the public interest and the interests of investors and consumers. Therefore in the administration of the Act the problems confronting the Securities and Exchange Commission, so far as they relate to the interest of investors is very much like those confronting you as investors in public utility securities.

But before discussing our experience with those problems let us have a few preliminary statements of history and background.

As long ago as 1926 Samuel Ferguson, President of The Hartford Electric Light Company of Hartford, Connecticut, a successful and independent company, called attention to the fact that the growing malpractices of holding companies had a profound effect upon their subsidiary operating companies, upon the ability of these operating companies to fulfill their obligations to the public and to investors in their securities and later predicted what has proved to be true, that the operating companies would have to bear the onus of animosities and prejudices engendered by the holding companies. The mistrust of holding companies culminated in the passage early in 1928 of Senate Resolution 83, commonly known as the Walsh resolution, authorizing the Federal Trade Commission to make an investigation of certain electric power and gas utility companies. As Chief Counsel for that Commission, while the investigation was in progress, it was my good fortune to have a part in it.

The criticisms of holding companies proved to be well founded, speaking generally; and the investigation showed that unregulated transactions, particularly those between holding companies and their own subsidiaries had in many instances been extremely detrimental both to investors and consumers. Excessive charges for services and the payment of unwarranted dividends threatened serious losses to the investors in senior securities of certain operating companies. In a number of other cases such practices hindered the

subsidiary operating company from properly filling its obligations to the public and consumers in its territory. The unearned or excessive service or management fee was a special dividend outside the fair return allowed by law, disguised as an operating expense. It was a betrayal of the theory of regulated rates, an imposition on the rate payer.

The Trade Commission investigation disclosed the wide spread, though not universal prevalence, of write-ups or mark-ups of property and investment accounts, based sometimes on no appraisal but more often on appraisals by affiliated interests, approved by no public authority estimating the cost of reproducing the property and giving consideration to no other element of present value. They were often blown up by fantastic overheads and were used for various purposes, such as to balance security issues, to create fictitious reserves and surpluses, to conceal losses and to overstate earnings. It was a private system of inflation in which a favored and self-appointed few did the inflating for their own benefit, exchanging pieces of paper based on inflated balance sheet figures in excess of cost, for uninflated United States dollars. In several systems one company was piled upon another, one equity upon another until the whole top-heavy structure collapsed. Some of them were tottering before October, 1929 arrived and thereafter failed. In time of stress, still speaking generally, the operating company proved hardier and more weather-proof than the holding companies.

To a considerable extent the disclosures of the Federal Trade Commission investigation formed the basis for the subsequent legislation called the Public Utility Holding Company Act of 1935. This Act, while primarily regulating the affairs and activities of electric and gas utility holding companies, strengthens and supplements to a considerable extent, but does not supplant, the State regulation of operating companies. It deals particularly with transactions between operating companies and their holding company parents.

The Act was signed by the President on August 26, 1935, but by its terms December 1, 1935 was set as the date upon which registration by holding companies with the Securities and Exchange Commission was required. The act of registration is the means by which the major provisions of the Act become effective. As you gentlemen know, eminent counsel questioned the constitutionality of the Act. It soon became apparent that a number of systems, including some of the largest, were reluctant to register. In November, 1935, the Commission stated that its policy would be not to harass the industry with a multiplicity of suits. It stated at that time: "...At least for the immediate future and until further notice the Commission does not intend to make any recommendations to or requests upon the Department of Justice for the institution of proceedings to enforce criminal liabilities under the Act. The Commission understands that the Attorney General has sent a circular to District Attorneys setting forth the attitude of the Department of Justice." The Commission also stated it was prepared to accept a notification of registration that expressly stipulated that the notification would at the option of the registrant be deemed void if the registrant's reservation of its constitutional rights were adjudged void or ineffective. Under the circumstances it appeared to the Commission that no good ground remained for any company to fail to file a notification of registration.

It is estimated that there are approximately 200 holding companies that are subject to the Act. Of these, 67 registered on December 1, 1935. The aggregate assets of the companies that registered as of that date amounted to about 20 percent of the total assets of the companies subject to registration. Among the initial registrants were The Middle West Corporation, New England Power Association, which had authorized the statement while the bill was pending in Congress that it could live under the Act, New England Public Service Company, Midland United Corporation and Lone Star Gas Corporation. From time to time since December 1935 a number of other companies have registered, including some of the large systems; for example, Utilities Power and Light Corporation, The North American Company, American Water Works and Electric Company, Inc., American Light and Traction Company and others. As of April 1937 we had a total of 81 companies registered, whose aggregate assets represent approximately 29 percent of the total companies subject to the Act.

A number of the companies that upon the advice of counsel elected not to register, decided in addition to bring injunction suits against the Government. It was apparent that active litigation of each of these suits involving substantially similar questions would be wasteful and expensive, inasmuch as a single test case could determine all the important questions involved in the interpretation of the Act. Accordingly on November 26, 1935, the Commission brought a suit in the United States District Court for the Southern District of New York against the Electric Bond and Share Company and its principal intermediary holding companies to enjoin activities declared by the Act to be unlawful in the absence of registration. The Electric Bond and Share system was selected for the test case because this system within itself presented a number of typical cases to which the Act by its terms applies. To avoid a protracted trial, a stipulation of facts was filed with the Court on June 30, 1936. On January 29, Judge Mack, before whom the case was tried, handed down his decision affirming the validity of the registration provisions and holding that the Electric Bond and Share Company and certain of its subsidiary holding companies could not use the mails or instrumentalities of interstate commerce to carry on certain transactions unless the holding company registered under the Act. The decision is to be appealed by the Electric Bond and Share Company and other defendants and will probably be passed upon by the Supreme Court in the near future.

At this point I think it may be helpful to describe the organization of that part of the Commission's staff which is charged with the administration of the Holding Company Act. Those who give virtually full time to matters arising under the Act as distinct from the Securities Act of 1933 and the Securities Exchange Act of 1934 include some 93 members of the staff. These include some 26 on the clerical staff, recruited from the ranks of the Civil Service and about 67 financial analysts, accountants, engineers, and lawyers, chosen on a basis of experience and qualification as experts.

The engineers, financial analysts, and accountants comprising our staff of experts have had practical experience in connection with the organization, operation, construction, financing and accounting of public utility enterprises. These include men who are acquainted with the operating conditions in every part of the country. Several of them have also had experience in foreign countries. The senior members of the staff have all had positions of

responsibility and many of them have had complete charge of utility operations or of the particular side of the business in which they specialize. The director of the Public Utilities Division, after an extensive experience with utility companies, served for a number of years as assistant to the treasurer in charge of the utilities investments of one of the largest life insurance companies of the United States, with investments in utilities securities running into hundreds of millions of dollars. During this time he had occasion to inspect the properties and study the operations of the larger utility operating companies of the country. Our financial men include one who was for many years financial vice-president and treasurer of a large holding company system and another who has had wide experience as an officer of a holding company system and for several years represented a group of banking houses in connection with the reorganization and simplification of corporate structures of one of the largest holding company systems. The chief engineer has had extensive experience as an operating and designing engineer for large utility companies, as a consulting engineer, and as chief engineer of one of the country's most active public service commissions. These are but a few examples.

An Assistant General Counsel and a corps of lawyers devote their entire time to public utilities.

By definition, holding company means "any company which directly or indirectly owns, controls or holds with power to vote, ten percentum or more of the outstanding voting securities of a public utility company or of a company which is a holding company." The framers of the Act realized that for the Commission to exercise jurisdiction over all the companies which would fall within such a rigid definition would not only be unnecessary in the public interest but might be quite detrimental thereto. Consequently the Commission is given power to exempt certain companies from any or all provisions of the Act.

In general the companies entitled to be relieved from full or partial compliance with the Act are those which are predominantly intra-state in character or which are predominantly public utility companies whose operations do not extend beyond the State in which they are organized and States contiguous thereto, or which are only incidentally holding companies, being primarily engaged in other businesses or which are only temporary holding companies because of having acquired securities in connection with bona fide debts previously contracted or in connection with the under-writing and distribution of the securities or whose utility subsidiaries do business entirely outside of the United States. In the majority of cases the simple filing of an application in good faith automatically gives the applicant exemption until the Commission acts on the application.

It has been the policy of the Commission while gaining experience in the administration of the Act to proceed slowly with these exemptions applications. However, 79 exemptions have been granted. Each application for exemption seems to present a special problem which can only be solved after careful study. One of the simpler cases that came before us, and yet one which may interest you, had to do with the application for exemption by a Southern textile mill which had a subsidiary operating company. This operating company supplied electric energy not only to the mill but also to the employees of the mill and to residents of the surrounding countryside. The

mill itself was by reason of its purchases of cotton and sales of textiles obviously engaged in interstate commerce, yet so far as its utility business was concerned it was entirely intrastate, and for that reason an exemption was granted, as the Act seemed to require.

Another typical case is that of the United States Steel Corporation and certain of its subsidiary companies. By definition these are holding companies because they own either directly or indirectly ten percentum or more of the stock of certain other companies engaged in the sale of electric energy or gas. Obviously the first mentioned companies are only incidentally holding companies, being primarily engaged in one or more businesses other than the business of a public utility company, and furthermore the income derived from their public utility assets forms no material part of their total income. Consequently, after investigation the Commission granted an order exempting these companies from the necessity of registering under the Act and from all those provisions of the Act which apply to registered holding companies.

During the past sixteen months the Commission has had cases under most of the operative sections of the Public Utility Act. Exclusive of applications for exemption which I have just touched upon, we have had presented to us 220 applications and declarations. Of these, 186 have been disposed of and 34 are still pending for one reason or another. You may be interested to hear about some of these cases. Section 6 of the Act provides, with certain exceptions, that no securities may be issued unless a declaration has been filed in accordance with Section 7, which sets up certain standards for the guidance of the Commission in determining whether a particular security should be allowed to be issued and sold. The principal exception from the necessity of filing a declaration under Section 7 is in cases of the issuance of securities by a subsidiary of a registered holding company when the issue has been specifically authorized by the State Commission of the State in which such subsidiary company is organized and doing business. In such cases the Commission is directed to exempt the issue by rule, regulation or order, subject to such terms and conditions as it deems appropriate. And yet no such rules or regulations have been promulgated and all applications for exemption have been handled by order. Inasmuch as during the past year the principal financing has been in the nature of refunding bonds of subsidiary operating companies, most of these new issues have been subject to the jurisdiction of a State Commission, and applications in connection therewith have constituted about half the applications and declarations having to do with the issue and sale of securities filed with us. Altogether there has been a total of 34 such applications for exemption covering the issuance of securities having an aggregate face or par value of $214,491,721. However the State Commissions have so supervised the securities coming under their jurisdiction that this Commission has in no case thought it necessary to attach any terms or conditions to its exemption orders.

The declarations under Section 7, which cover the issuance of securities by holding companies or by subsidiary companies in states where there is no commission supervision, were 37 in number and aggregated a total of $521,532,442 of stated or par value. In these cases the prime responsibility rests on this Commission, which is required among other things to determine whether the security is reasonably adapted to the security structure and earning power of the declarant, that the fees, commissions and other expenses of the issue are not unreasonable and that the terms and conditions of the issue are not detrimental to the public interest or to the interests of the investors or consumers.

Following our practice of cooperation and informal conference with declarants we have been able to make a number of constructive suggestions which were adopted by the declarant. In one instance a maintenance and renewal clause was introduced into the mortgage which materially improved the quality of the issue. In another case we suggested that fewer bonds be issued and the balance of the capital required be furnished by a serial debenture that could be paid off largely through the reduction in fixed charges which were to be brought about by the refinancing. In still another case, that of a company emerging from reorganization under 77B proceedings, which proceedings had been started before this Act became effective so that the plan of reorganization did not come before the Commission under Section 11(f), we were able to persuade the reorganization committee and presiding judge to insist upon a sealing down of creditors' claims so that the securities to be issued upon reorganization bore a close relation to the approximate value of the bankrupt's estate.

In connection with the same reorganization matter there was a proposal to use a portion of the income for the repurchase and retirement of the securities to be issued. The method proposed appeared to this Commission to be inequitable and we were able to suggest another method which gave greater protection to all classes of security holders.

The close scrutiny that the Commission has given to underwriting spreads has had its effect in greatly reducing this particular cost of financing, and in the Kansas Electric Power Company decision of last December both the majority and minority opinions of the Commission gave notice that it expects trustees under indentures to function in the interest of the bondholders and that the bankers' spread shall be the result of genuine bargaining and not of a mandate imposed on operating companies by bankers in a position of influence or control through ownership in the parent company or otherwise.

Sections 9 and 10 have to do with the acquisition of securities and utility assets. We have had only a few cases arising under these sections of the Act and one may be of interest to you. It involved a sale by New England Gas and Electric Association, affiliated with Associated Gas and Electric Company, to Massachusetts Utilities Associates, controlled by New England Power Association, of certain minority stocks of subsidiaries of the Massachusetts Utilities Associates in return for the control of Plymouth County Electric Company and Plymouth Gas Light Company. As a result of this transaction Massachusetts Utilities Associates will be able to collapse certain of its subsidiary holding companies and thereby greatly simplify its corporate structure. On the other hand New England Gas and Electric Association will be able to combine its newly acquired Plymouth properties with two others previously owned, New Bedford Gas and Edison Light Company and Cape and Vineyard Electric Company, serving adjacent territory, into one integrated operating company.

Subsections (a) and (b) of Section 11 are the sections of the Act concerning which there has been the greatest controversy. They contain the provisions in accordance with which, as soon as practicable after January 1, 1938, the Commission is required to take steps looking to the simplification of the holding company structures in the United States. It is remarkable that heretofore the Government has had so little power as to the direction which growth and ownership should take in an industry which is said to be dedicated to a public use and to be affected with a public interest, which has had delegated

to it by the State the sovereign power of eminent domain, which enjoys very valuable protection against competition, which so often occupies streets and highways and dams the great interstate and international streams without charge and which owes its corporate existence to the State.

To you as investors I say that the Commission realizes the grave responsibilities imposed upon it by the provisions of subsections (a) and (b) of Section 11, and will be slow to move until a careful and exhaustive study has been made of each particular situation. The general principles which may direct administration of this section are being studied by a group assigned for that purpose but no specific problem has been considered or discussed. In the meantime several of the companies are moving toward the simplification of their corporate structures, which is one of the ideals of the Act, sometimes under and sometimes not under the auspices of the Commission.

There are other subsections of Section 11 concerning which there is less controversy, notably Section 11(e) having to do with voluntary reorganization, Section 11(f) with reorganization under court proceedings and Section 11(g) having to do with solicitation of proxies in connection with reorganization plans.

We have had no cases as yet under Sections 11(e) or 11(f) but have recently had before us two quite interesting cases involving Section 11(g), the first being the proposed reorganization of Illinois Power and Light Corporation and the second that of International Paper and Power Company. Both were voluntary reorganizations in accordance with plans proposed by the management, which are to be acted upon by the shareholders at meetings called for that purpose. In each of these cases the company representatives and the staff of the Commission collaborated with the result that the letter of solicitation gives much more complete and detailed data for the guidance of the shareholders than has been customary in the past. Furthermore the staff of the Commission was able to make several suggestions which were adopted and resulted in an improvement in the plans as originally proposed. In each case the report of the Commission was designed not to express an opinion either in favor of or against the proposal, but simply to point out the salient facts which the shareholders should consider in arriving at a decision as to whether the plan was favorable or unfavorable to their particular interests.

When this paper was prepared, the Commission had not passed upon the reorganization plan presented by the International Paper & Power Company. The problem is complicated by the fact that the Company filed an application for exemption from all the terms of the Act and has not registered. If and when a report on the plan is made by the Commission, the management will send copies of it to all stockholders who are to consider the plan. In two other instances in which the reorganization of subsidiaries of registered holding companies was planned, tentative views expressed by the staff in preliminary conferences probably will result in the withdrawal of one plan and the extensive revision of the other.

Section 12(c) gives the Commission complete jurisdiction over payment of dividends. However, it was felt that at present all that was necessary was to promulgate a rule which forbids the payment of dividends out of anything but earned surplus and requires an application to the Commission only with reference to a dividend which is to be paid out of capital or unearned surplus. However, the staff is making a careful study of what a proper dividend policy should be.

In the past one of the greatest abuses of the holding company system was in excessive or unearned management and service fees collected by parents from subsidiaries. The Act prohibits such charges between affiliates except at cost and except by subsidiary or mutual companies organized to render service. Each of the registered holding company systems in which services are performed for subsidiary companies have organized one or more service companies and made application under Section 13 for their approval. There is a wide variation in the kind and extent of service to be given by these companies and the accounting procedure is set up to assure that such services shall be charged at cost. In each instance the Commission has approved the applications presented to it and has not attempted to arbitrarily require any particular method of allocation of costs. It feels that experience is necessary to determine what, if any, particular method will bring the best results. While granting the greatest freedom of method the Commission has made it perfectly clear that the various methods adopted must be justified by the results, that is, the companies must show that the method of allocation is fair and equitable. In order to measure these results and to determine if the service companies are functioning as required by the Act, the Commission promulgated on August 1, 1936 a Uniform System of Accounts for Service Companies. The first reports under this Uniform System of Accounts are now being analyzed by the staff of the Commission. It is possible that in addition the Commission's accountants will make certain field studies of methods used by different companies.

The Commission has been impressed by the desire of the industry to allocate charges for services on an accurate cost basis and feels that the industry will readily accept any suggestions for the improvement in methods which will result when the companies and the Commission pool their experiences.

In addition to developing a uniform system of accounts for service companies the Commission's accountants made a careful study of holding company accounting and promulgated on January 1, 1937 a Uniform Classification of Accounts for Holding Companies. Complete reports under this system will not be available until the Spring of 1938. Under the classification, investments and properties must be recorded at cost and provisions are made to prevent the inflation of assets and earnings by improper accounting.

In general it may be said that the Commission has employed the first sixteen months during which the Holding Company Act of 1935 was effective in organization and in gaining experience in the administration of the Act. While only a fraction, although an important fraction of the industry has elected to register under the Act, we have had presented to us a great variety of cases and I think I may say that these cases have been handled expeditiously, with the result that the companies which have accepted our jurisdiction have not been hampered in the normal conduct of their business but on the contrary have been materially benefited by registration. I feel sure that investors in their securities have been.

The Middle West Corporation, New England Gas and Electric Association, and New England Public Service Company, to mention three of the largest companies which were registered during the year 1936, have been very active in refinancing the obligations of their subsidiary operating companies. They have arranged to save many millions of dollars in fixed charges, with results that should be of benefit to consumers in the territories served by them.

As a result of the experience by these companies in living under the Act, a number of large holding company systems that initially refrained from registration have registered during the early months of this year. The Commission's staff is so organized that it can handle a considerably increased volume of work, so that the new registrants can be assured of continued prompt and efficient handling of their applications and declarations.

At the risk of some repetition let me sum up my conclusions and observations at the end of these sixteen months' experience in the administration of the Act. Again I say that the Commission sees nothing in the Act looking or working toward the nationalization or destruction of the industry. A good administration of it should improve the investment quality of the securities of operating companies and should wrench the predatory type of holding company and entrepreneur away from the jugular vein of the operating companies. Many of the ideals and objectives of the Act are being sought by companies which have not registered. I feel the Commission has made a definite contribution to the improvement of accounting methods and that this contribution should increase as time goes on. The Commission has had very little to say about the accounting methods of operating companies. I believe that in this respect the policy of the Commission, so far as it has the right to say anything, will be that the operating companies should adopt the classification of accounts prescribed by the regulating authorities of the states in which they operate and that the Commission will not attempt to interfere with this unless some accounting procedure is adopted which defeats or impedes the purposes of the Act. The Act gives the Securities and Exchange Commission no authority to regulate rates and it is my personal belief for the present, at least, the regulation of local retail distribution rates should be left in the hands of the local regulatory authorities.

Laying Sections 11(a) and (b) to one side, since we have had virtually no experience under them, I feel that the sixteen months have shown that the Act is workable; that nothing in it interferes with the legitimate functions of the registered companies and their subsidiaries; that its operation has worked public benefits and will strengthen state regulation.

The Commission welcomes each addition to the number of companies registering under the Act and looks forward to the opportunity of cooperating with them in solving the common problems involved in protecting the interest of the public and of investors and consumers.

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