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"The SEC and National Defense"

ADDRESS

of

**SUMNER T. PIKE**

*Commissioner, Securities and Exchange Commission*

before the

**NEW YORK SECURITY DEALERS ASSOCIATION**

New York City

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There is today in this nation a singleness of purpose. We are united towards one overriding objective - making ourselves so strong that no power on earth will dare to challenge our way of life. The towering necessity for attaining this objective with all possible speed overshadows all other needs both in our national and in our personal lives. Differences which were important not long ago have melted to nothing as the inferno abroad has drawn closer to our shores.

Tonight I am not going to talk about problems arising from the relationship of the brokers and dealers to the Securities and Exchange Commission. I shall talk about our common problems in connection with national defense. I shall tell you some of the things we are trying to do in Washington. And I want to discuss with you how you can take a greater part in this defense job.

Discussion of finance during defense refers sooner or later to control of capital issues. This is natural because, at the time of the First World War, capital was not plentiful in this country. It had to be conserved and directed into the most useful channels of our war economy. It was essential that capital should not be frittered away on projects not absolutely necessary for the creation and support of our army and navy.

Today, our problem is somewhat different. Of all the resources necessary for our present national defense drive, money is probably the most abundant. Reserves of private capital today appear to be comparatively plentiful. To be sure, our capital is not as productive as it should be. Nonetheless, we seem to have ample reserves. Because of these reserves, control of capital issues to conserve capital funds seems unnecessary for the present.

Of course, the cost of defense absorbs a great portion of the nation's income. Or, to state it another way, military expenditures must utilize a great portion of the nation's capital, labor force, natural resources, and plant equipment. In the economic sense, a considerable part of our productive resources is used to produce military goods instead of civilian or commercial goods. Since our full productive capacity has not yet been reached, however, the economic problem may not be so much one of shifting productive efforts as increasing them on all fronts. A main function of finance is to make it possible to attain shifts and increases in productive effort. The scope of defense finance, therefore, goes much more deeply than the problem of available capital. We must always keep in mind that basically, the problem is one of shifting and increasing the employment of our resources -- labor, materials and equipment. A primary economic balance must therefore be sought between production for defense and production for non-defense purposes.

There are many essential materials which must be conserved. I refer, of course, to raw materials, to products of industrial plants, to many classes of labor. The wasteful or unwise employment of these resources now must be guarded against, and it is of course to this end that the Advisory Commission to the National Defense Council, the Office of Production Management, the Priorities Board and other special agencies and offices have been created to which leaders of business, finance and government are now giving their time and energy. Control of capital borrowing, as such, has not yet been necessary. However, we must be careful that our abundance of capital does not promote competition with the national defense effort for these resources.

This problem of competition with the national defense program for our nation's resources has been brought forcibly to our attention in connection with our job of protecting the investor under the Securities Act. Only a few months ago, after we were well into the defense program, a registrant came to our Commission with a project to raise funds for the building of a grandstand at a race track. The issue was effectively registered and, so far as I know, the money was raised. Later, we got to thinking about this, and other issues of the same kind. We began to wonder about the materials and labor which would be necessary to complete the project. Steel forms would undoubtedly have to be used, and labor which could handle that type of construction. These problems were brought more sharply to our attention, when, a little later, several commercial airlines registered issues the proceeds of which were to be used for the purchase of additional commercial airplanes. Not very long after these issues were registered, and the money raised, these airlines were told that they could not have their planes because of the needs of the Army and Navy. Then there was the big biscuit company which raised money, after registration, for the erection of a \$1,500,000 new cracker plant in a mid-Western area where there is great need for new construction for defense purposes. Here again the question was -- could it get the materials and labor to do the job. I do not for a minute suggest that any of these enterprises was contrary to the national objective of total defense. I don't know the answer. But two main problems arise. The first is, do the Priorities Board and the labor control administrators within the national defense organization know about these projects and second, are we permitting, by inadequate disclosure, the investment of the public's money in projects which National Defense cannot permit to materialize? In other words, are we adequately protecting the investor?

We have recently discussed this matter with Chairman Stettinius of the Priorities Board and Mr. Hillman's office, and we have developed the following working arrangement. I am now authorized to state that henceforth, where new projects are concerned, we shall regard as "material" for registration purposes any information relating to priorities for raw materials and equipment or the availability of labor necessary for the completion of the project. Wherever it appears that any of the proceeds of a securities issue registered with us are to be used for new or additional facilities, such as buildings or machinery, we shall contact these two branches of the National Defense organization. If they tell us either that materials or labor are unavailable or likely to be unavailable for the purpose specified in the registration statement, we shall require that this information be prominently displayed in the registration statement and prospectus. Similar disclosure will be required whenever the Priorities Board or labor director of O.P.M. indicates that there may be substantial delay in obtaining the necessary materials, equipment or labor. It may well be that this disclosure will discourage financing of such projects. Of course, our interest is that the prospective investor will be sufficiently on guard so that he can make an enlightened judgment. As a result of this program, the National Defense organization will have all efforts for the public raising of money for new projects brought to its attention whether or not priorities have already been sought, and we shall be properly warning investors that they may be putting their money into impossible or unlikely undertakings. The Securities Act already gives us ample authority to do this job. For priorities information at a time like this is obviously necessary to full and truthful disclosure to the investor.

Of course, the Securities Act is also designed to prevent fraud. This enables us to prevent the diversion of the public's money and the nation's resources into fraudulent channels, and conserves them for legitimate business and bona fide defense industries. All kinds of companies, for instance, have mushroomed in the last year in the name of national defense. Our investigators all over the country have been watching these promotions and it is clear that some of them are plain, unadulterated frauds. These frauds are ruthless efforts to prey upon the patriotic emotions of small and unsophisticated investors. Fortunately, the securities laws are on the books. By criminal prosecution and by injunction we prevent expenditure of the public's money on fraudulent schemes. Money that might have gone into phantom factories is thus saved for legitimate business, including defense industries.

Under the Public Utility Holding Company Act the problem of priorities of materials has also arisen in connection with utility financings. We know that greatly increased generating facilities are rapidly becoming necessary for national defense, and at first blush it seems inconceivable that such utility projects should not obtain a clear track. From the standpoint of priorities, however, there are actually situations where this is not true. Battleships and cruisers require enormous generating capacity, and we are building a great number of these today. The question has been raised, however, whether our present capacity is adequate to meet our increased naval and industrial requirements. Not long ago, I heard of an instance where a battleship had to be tied at dock for several months to supply the power needs of an expanded naval post ashore. The net result is that additional generating capacity must meanwhile be carefully apportioned between our military and our civilian needs, and then, carefully reapportioned between civilian projects in areas most vital to national defense. All this until our capacity to build generators can be increased to meet our needs. To

this end, this Commission must scrutinize all applications by utilities to raise funds for generating facilities. Under the Holding Company Act, of course, our powers over utility financings are more pervasive than under the Securities Act. We shall be alert that utility financings for additional facilities are reviewed from the standpoint of national defense priorities of materials and equipment and the availability of labor.

In these connections, private finance can play a role. You can spot these things as they arise, even before they come to us. When a prospective issuer talks to you about preparing an issue, you can raise the priorities and the labor question, and discourage issues which appear to be out of line with the defense program - or at least have him make sure that the project is not out of line. Our primary function of protecting the nation's investors is inseparably linked to the fundamental endeavor to make the nation secure. In short, we can jointly aid the defense program by preventing the diversion into illusory ventures of funds and resources which might otherwise stimulate bona fide defense projects. I realize that in these days, it is difficult for the financial community to discourage issues. But because I know you, I have no doubt that you will do it when necessary to our common defense program.

The SEC has also participated in another aspect of the defense program. Under the Second Revenue Act of 1940, special accelerated amortization deductions are permitted for additional emergency plant facilities. These special amortization deductions, however, are granted only if a so-called certificate of necessity is obtained from the Secretary of War or Navy and the Advisory Commission to the Council of National Defense certifying the need of the additional plant facilities in the interest of national defense during the emergency period. Errors may result in corporations gaining undue tax advantages and unconscionable profits, contrary to the intent of Congress, and might possibly lead to dislocation of our economy after the emergency is over.

Facts are important. And that is where the SEC comes in. We have made our facilities available for aiding in the investigation of applicants for such certificates, thereby helping to get the facts for the War and Navy Departments and the Advisory Commission, where they want to supplement existing information. After we have delivered the relevant facts, the defense authorities can make an informed judgment. The decision as to whether the certificate of necessity should be granted or denied appropriately rests with the defense authorities, not with us. We are merely advisory fact-finders for the defense authorities when they need us. But fact-finding, I am sure you will agree, is a necessary and important preliminary job.

The Commission's duty to integrate and simplify holding company systems under section 11 of the Public Utility Holding Company Act is another front on which the arsenal for democracy is being forged. Before I go into that, I want to remind you that section 11 isn't only a problem of the utility industry. It's another field in which you and we can work together for the common good. The successful accomplishment of the task of integration and simplification so that their benefits may be quickly felt in the national defense program is a very large and important job for the financial community. But if it is large, it is still one which will not be without its rewards for those who play a part. The section 11 program is on its way. It will be done and it will be completed as speedily as practicable. The distribution of securities is your business. It is the business from which you make your livelihood. The realists among you will acquaint themselves with the utility situation and help work out the section 11 problems. They who allow emotional opposition to the objectives of the Holding Company Act to obscure their vision will be left by the wayside while the more practical members of the financial community get the business and reap the benefits.



The electric and gas operating utilities are vital to the national defense program. Section 11, however, is aimed at the holding company. Section 11 will not uproot or destroy physical operating facilities. To the contrary, the Act is designed to improve the operating efficiencies and financial health of the operating companies. It's the holding company superstructure above the vital foundation of operating companies that we are directed by the Act to integrate and simplify.

Efficiency in operation of utilities is necessary to defense and the public good. Efficient operation requires intimate knowledge of the operating property, local industrial needs and community problems. Remote control by holding company executives in large financial centers is scarcely compatible with efficient operation. Local operating executives who are animated by puppet strings pulled in distant financial centers cannot give us the benefits of localized management and efficient operation. Only management which is on the operating scene, not absorbed in the far flung problems of running a utility empire of four or five layers spread over half the world can do the job with the high degree of efficiency that is now vital. Integration and simplification will increase utility managerial and operating efficiencies which are essential to the effective mobilization of industry for defense purposes.

The present absence of integration obstructs an effective national defense program. Lack of integration of utility properties makes power more costly and tends to block proper coordination of power resources. The growth and extension of holding companies has had little relation to economy of management and operation or the integration and coordination of related operating properties. Desirable grouping of adjacent properties has been prevented in many instances by rival holding company systems which gobbled up everything in sight without regard for their digestive abilities. For example,

look at the utility situation in the State of Ohio, one of the most important steel, rubber, machine tool, munitions, and powder plant manufacturing centers in the country. The entire State of Ohio is split up into isolated islands of separate utility properties owned by rival holding company systems. I counted more than 50 different islands of holding company system operating properties on the map of Ohio the other day, and that doesn't begin to take in some of the municipals. Holding company systems such as North American, Commonwealth and Southern, American Gas & Electric, United Light & Power, Columbia Gas & Electric, Cities Service Power & Light, American Water Works, Associated Gas & Electric, Utilities Service Company, Crescent Public Service Company, United Public Utilities Company, Midland United, and others all have their own preserves in this state. In many cases their own properties are separated from each other by intervening properties of other companies. Proper coordination of power facilities in Ohio is a tough assignment because of this holding company system hodge-podge.

The country-wide scatteration of electric utility service areas and the consequent paralleling and "leap-frogging" of transmission lines are the natural results of a development which has come about without proper regard for regional considerations. Under the present setup, transmission lines have been badly located and frequently parallel and jump over those of rival systems. Generating and transmission facilities sometimes have been built because of holding company benefits and without regard to the power needs of the area served. The existence of rival holding company systems in an area which should be a single integrated system causes the building of unnecessary generating plants and, in some cases, an uneconomical location of generating plants, resulting in waste of our power resources as well as investors' and consumers' money. Not only this, but the pressure of the holding company to take up earnings from its operating subsidiaries has had a marked effect on

the condition of generating stations. Inadequate depreciation allowances and reserves increased reported earnings of operating companies which were siphoned off by parent holding companies. Adequate depreciation policies and plowed back earnings would have enabled many operating companies to build new, modern generating plants. Instead, because of holding company appetites for subsidiaries' earnings, we have old, obsolescent power plants still being used for national defense.

I want to illustrate the unfortunate situation frequently caused by scattered holdings of rival holding company systems. An Army Aeronautical Research Laboratory located at Langley Field near Newport News, Virginia required additional power. Virginia Public Service Company, a subsidiary of the Associated system and formerly an Insullite, happens to have an isolated eastern division, far removed from the rest of its facilities, which serves Langley Field. Virginia Public Service, however, had neither the capacity nor the money to meet the need of this army station. Now it so happens that Virginia Electric and Power, a subsidiary of the rival Engineers' Public Service system, is logically located to serve the Langley Field area, and had the capacity and necessary financial resources to furnish the needed power. Yet because Virginia Public Service had previously stretched out into this territory, it was necessary to deal with it and for it in turn to go through months of negotiations with Virginia Electric and Power to work out a plan for extending power facilities into the area. Negotiations were not successful. Finally, the Government found it necessary to begin construction of a 10,000 kilowatt power plant to take care of the peak loads at Langley Field. To this day the army station at Langley Field needs more power. Lack of integration of operating facilities caused unnecessary delay on defense work. The program under section 11 will eliminate these unfortunate delays and breakdowns in defense by providing for integrated utility systems which are devised by engineers' planning rather than financiers' scheming.

The section 11 program is aimed at integrating properties like this so that the crazy quilt situation will disappear. As the Federal Power Commission's reports on electric power requirements and supply indicate, we may need a great deal of utility expansion in the next few years to meet the demands of national defense. It is urgently necessary - not only for national defense but to protect us from paying excessive rates for the next few decades - that these new facilities be planned and operated as coordinated parts of integrated systems. We can no longer afford the wastes and inefficiencies of the past. I believe that the widely scattered properties of today show that the holding companies haven't done much sound planning. And I am convinced that the SEC integration and simplification policies will make possible intelligently planned power programs which will effectively coordinate the needs of national defense.

Integration and simplification will also improve the financial status of many operating utilities. The holding company by and large has not done the job of sending downstream equity money to its operating subsidiaries. The record will bear me out that holding companies have proceeded most reluctantly in putting their money into operating subsidiaries. Before the Utility Act, the favorite device of pyramiding was often based on running a shoestring investment into control of a vast number of operating companies. So small was the holding company stake in its subsidiaries at times that Congress, in passing the Holding Company Act, specifically mentioned the evils caused by "disproportionately small investment." And before the Act, the studies of Dr. Moulton of Brookings Institution showed that very little of the money put into holding company securities went into productive capital for operating companies. The holding companies by and large financed their subsidiaries by selling senior securities of those subsidiaries to the public.

I want to give you some figures that were startling to me. From November 1, 1935 to the end of 1940, there have been registered with the SEC under the Holding Company Act security issues by holding companies in the total amount

of \$466,000,000. Of these, our records show that securities amounting to a grand total of about \$8,000,000 were sold by the holding companies for expanding the productive power facilities of their operating subsidiaries. And of this total \$1,250,000 was raised by a RFC loan. Now these figures do not take into consideration other funds sent down to the operating companies from sale of portfolio securities or from dividends or interest received. But it does give you an idea of the holding company as a means for raising money for expansion of power facilities of its subsidiaries. These figures would seem to kill any contention that the holding company has been a valuable vehicle for financing the operating companies. If the holding company does send money downstream, it appears to serve largely as a mere conduit, taking up money from the operating companies and then releasing it to them. Even in this regard, it is known that frequently the parent has taken up excessive dividends and then returned them to the operating subsidiary in the form of interest bearing debts which rank ahead of publicly held preferred stocks.

The operating utility, cut loose from holding company shackles under section 11, can borrow privately or publicly just as well as it does today. In fact in some instances its credit might be improved if the holding company is taken off its back. For the most part the operating companies are in a stronger financial position than the holding companies: yet many of them are unable to undertake new financing necessary for defense construction only because they are tied to the holding company. For instance, this may occur where an operating company needs additional facilities but cannot sell additional senior securities because the holding company has already overloaded it with excessive bonds and preferred. New money might possibly be raised on common stock but the controlling holding company won't let the public in on the ground-floor common stock investments in its operating subsidiaries. And the holding company parent has neither the money nor the credit necessary to subscribe to additional common itself.

The corporate simplification program contemplated by section 11 (b) (2) of the Act is designed to reorganize the holding company and the corporate structure of the holding company system so that healthy, vigorous utilities may emerge to serve the public interest. Some of the holding companies have been so sick that they couldn't possibly do their job of financing operating subsidiaries even if they wanted to. In many instances the corporate simplification program will enable a holding company to clean up arrearages and take a new lease on life with a sound capital structure. For the first time in a decade some of the holding companies will be able to raise money on their own for expanding the operating facilities of their subsidiaries.

For the past several years our experts have cooperated in planning an overall power program for the nation's defense needs. Our knowledge of the nation's power requirements and supply convinces us that we can aid the national defense program by an intelligent, speedy enforcement of section 11. Cooperation from the utility industry and the Street's representatives would be in keeping with a true mutual national defense effort. And the cooperation that we have recently received from executives of some of the major systems in working out parts of the program I commend to the rest of the utility industry.

As for the investment bankers and dealers of the country, there is little question in my mind that they can do a fine job in meeting the financial problems raised by integration and simplification. The ice is breaking in this field. Before long you will have the job of distributing the shares of many operating companies to the public. I repeat that it is a very important undertaking from the standpoint of national defense and I know you can do it well. The electric and gas operating utilities are sinews of our national strength. We must free them from the handicaps which are preventing their proper development.

A powerful defense must be predicated upon a vital working democracy. For if our democratic system fails to work, the defense machinery will be powerless. We must strive together to vitalize the working democracy in finance upon which a vigorous defense must be built.