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SECTION 11 OF THE PUBLIC UTILITY HOLDING COMPANY ACT

ADDRESS

of

ROBERT E. HEALY

Commissioner, Securities and Exchange Commission

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SECTION 11 OF THE
PUBLIC UTILITY HOLDING COMPANY ACT

I am happy to speak before a group of practising lawyers. It is not difficult to understand why. I had over thirty years of active practice before joining the SEC. Also I have had somewhat close contact with a number of lawyers who were not practitioners but teachers. I have greatly admired their learning and erudition which were far greater than any I could ever hope to achieve. There is, however, one great educational force which some of them have missed. They have never had the chastening and stimulating experience of meeting a client just after losing his case. They have never listened to a client say: "I did everything exactly as you told me to and now see where I am." But tonight some of the advantages they enjoy will be mine for there can be no effective appeal from anything I say here.

I assume that Section 11 was chosen because that section and more specifically subsection (b) (1) thereof is the only section of the Act as to which much controversy continues. The benefits which have come from a painstaking administration of those sections relating to security issues, the reform of accounting and the suppression of the predatory type of service company -- all have finally been accepted. Little by little, the attacks on the other sections have receded in the face of realized benefits. 11 (b) (1) remains under attack, yet its accomplishments will, I predict, in the end win for it the same acceptance which its fellow sections now enjoy. But I have not come to praise Section 11 (b) (1) but as a lawyer to discuss its mechanics, its meaning, etc., with lawyers engaged in the practice of law.

I hope that this paper and the discussion to follow will stimulate and clarify our thinking concerning that section. You will understand, of course, that the views I express here do not represent the views of the other members of the Commission. Many of those views are quite tentative in character.

It is not my purpose to discuss legislative history. However, I should like to end one misconception which has been repeated so often that it is generally accepted as true. I refer to the notion that Section 11 passed the Senate by a margin of one vote. It is true that in the course of Senate debate a series of amendments were introduced by Senator Dietrich which he characterized "as designed to eliminate from this bill the so-called 'death sentence'" and these amendments were rejected by a vote of 45 to 44. But the prototype of Section 11 then before the Senate was far more drastic than the present Section 11. Furthermore, the final vote on the passage of the Senate bill including the old drastic form of Section 11 was 56 to 32, a majority of almost two-thirds -- and the House bill was passed by a vote of 323 to 81. The conference report which compromised some of the differences between the Senate and House bills, was agreed to by the House by a vote of 222 to 112. Presumably, the conference report met with little opposition in the Senate since no vote was reported when the Senate agreed to the conference report. Furthermore, it was for the first more drastic Senate draft that the label "death sentence" was devised. This label was intended to help to prevent the passage of that draft and possibly the present Section 11 (b) (1). Unfortunately, it has led to much misunderstanding of Section 11 (b) (1) and has made the enforcement

of this particular law of the United States somewhat difficult. Today it seems as plain as day that the Act is proving to be a life saver for the operating companies without which of course there would be no utility industry.

Before we turn to Section 11 itself, we ought to glance for a moment at Section 1 of the Act which is entitled "Necessity for Control of Holding Companies". That section, after setting forth in summary form the abuses which had developed in connection with public-utility holding companies, declares it to be the policy of the Act:

> ". . . to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided" in the Act.

This is not a declaration favoring the wholesale elimination of public-utility holding companies but for their elimination "except as otherwise expressly proviced". A little later we shall see that it is otherwise expressly provided to a considerable degree, although there undoubtedly will be situations where the elimination of some holding companies, especially in heavily pyramided structures, will be desirable or necessary.

Another section which must be consulted if we are to have any understanding of Section 11 is Section 2 (a) (29) which contains the definition of an integrated system. The definition found in Section 2 (a) (29) is as follows:

> "'Integrated public-utility system' means --
>
> "(A) As applied to electric utility companies, a system consisting of one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single

> interconnected and coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation; and
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> "(B) As applied to gas utility companies, a system consisting of one or more gas utility companies which are so located and related that substantial economies may be effectuated by being operated as a single coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation: *Provided*, That gas utility companies deriving natural gas from a common source of supply may be deemed to be included in a single area or region."

Now for Section 11 itself. We find in Section 11 (a) a provision that it shall be the duty of the Commission to examine the corporate structure of every registered holding company and every subsidiary company thereof, the relationships among them, the character of their interests, the properties owned and controlled by them, and

> "to determine the extent to which the corporate structure of such holding-company system and the companies therein may be simplified, unnecessary complexities therein eliminated, voting power fairly and equitably distributed among the holders of securities thereof, and the properties and business thereof confined to those necessary or appropriate to the operations of an integrated public-utility system."

Section 11 (a) deals with two general subjects: (1) simplification of corporate structure, including fairness of voting rights; (2) integration.

The fact that Section 11 (a) directs the Commission to "determine" the extent to which the corporate structure of the holding company and its subsidiaries may be simplified and the business and property thereof confined to those necessary or appropriate to the operations of an integrated system led several of the large holding companies, and several students of the statute, to contend that the Commission should make a determination as to simplification and integration *before* instituting proceedings under Section 11 (b). Predetermination or prejudgments of this character seem to me very much at odds with our system of jurisprudence. Furthermore, it seems clear that Section 11 (a) is an introductory statement of objectives, telling us what Congress wants accomplished and that Section 11 (b) sets forth the procedure for accomplishing those objectives. Section 11 (a) makes no provisions for the issuance of an order or for notice and opportunity fot hearing. But 11 (b) which makes it the duty of the Commission to require certain action by order says that the order cannot issue until after notice and opportunity for hearing. Section 20 makes the same provision as to all orders. In other words, it is quite clear that the Commission should and must give the holding company system in question an opportunity to present evidence and to state its case before any final determination is made. That is in accord with one of the basic principles of our system of laws that decisions are properly made only after hearing the parties involved as to both the law and the facts.

Section 11 (b) is divided into two parts. The first part, 11 (b) (1), directs the Commission to require each registered holding company and each subsidiary company thereof to "take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system", provided that the Commission must permit a registered holding company to control one or more additional integrated public utility systems if certain specified standards are met. In this respect Section 11 (b) (1) modifies and extends the substance of Section 11 (a).

It will be noted that Section 11 (b) (1) recognizes that holding companies may already control various integrated systems. The crucial problem posed by 11 (b) (1) is: how many integrated utility systems should a holding company be permitted to control? In this respect, the philosophy of Section 11 substantially resembles that of the Sherman Act which a Republican president, Benjamin Harrison, signed in 1890 and that of Section 7 of the Clayton Act which a Democratic president, Woodrow Wilson, signed in 1914. Support for this view is found in the Senate Resolution (Senate Resolution 83 (February 15, 1928) 70 Cong. Rec. 3054) authorizing the Federal Trade Commission's investigation of utility corporations, wherein that Commission was directed "to report particularly whether any of the practices heretofore in this resolution stated tend to create a monoply or constitute violation of the Federal Antitrust laws".

It has been the traditional policy of Anglo-American law and particularly the policy of our federal law to oppose monopoly and foster competition. In 1889 the Supreme Court of Illinois, in the *Peabody* case (130 Ill. 268, 8 LRA 497), would not permit two gas companies in Chicago to merge, holding that the proposal was contrary to public policy. But, in after years this doctrine was modified by the states and it is rare indeed to find a city in which there is more than one electric or gas company. (There are a few.) But although the federal attitude had not changed, monopolies were not only created in large cities or areas but control of the monopolies was being concentrated in a few hands. Thus, sixteen holding company groups controlled over three-fourths of the total generation of electric energy in the United States in 1932 and several of them were controlled by a super-holding company. Even the most insistent defender of our American system of corporations can forgive us for wondering if the legislators, who first changed the common-law rule that one corporation could not own the stock of another, even imagined what the results of that change might be.

It is quite evident that Congress was of the opinion that while the regulation of intrastate operating utility companies was primarily a non-federal problem -- and whether intrastate companies should or should not be permitted by law to maintain virtual monopolies within the state was primarily a matter for state determination -- the broader matter of how many of these companies in how many states should be owned or controlled by a single holding company was a matter in which the national government had a legitimate interest and concern.

After expressing the general or primary purpose of limiting the operations of the holding company system to one integrated utility system, Section 11 (b) (1) goes on to provide that under certain circumstances the holding company shall have the right to own more than one integrated system. These circumstances or standards are described in three subparagraphs of 11 (b) (1) labelled with the capital letters A, B and C. They are often referred to as the A, B, C standards of Section 11.

Once it is established that the respondent holding company owns more than one integrated system the question may be raised as to who has the right to select or designate the principal integrated system. The Act does not expressly state whether the selection of the single integrated public utility system retainable as the principal system is for the holding company to make solely on the basis of its own wishes, or for the Commission to make on the basis of evidence and with due regard to the public interest. Those who argue that this choice is the prerogative of the holding company point out that in those cases where holding companies have been found in violation of Section 7 of the Clayton Act by acquiring two substantially competing corporations, the court's decree of divestiture and the Federal Trade Commission's cease and desist order have invariably left to the holding company the decision as to which company it should retain and which it should release. In support of the position that the Commission should make the choice, it is argued that if a holding company owns one large important integrated system and a number of scattered, rather small and unimportant systems, it would be an offense to the objectives of the Act to permit the holding company to

devise a Section 11 gerrymander and designate one of the smaller, unimportant systems as its principal system for some reason unrelated to the purposes of the statute. An intermediate position is that the holding company may make the selection subject to the approval or disapproval of the Commission based upon evidence and judged in the light of the public interest and the interests of investors and consumers. Assuming that the holding company is permitted to make the choice of its principal system, the interesting question is posed: what happens if the holding company refuses to make a choice? Actually the Commission has not yet been presented with this problem and therefore has had no occasion to decide the point. Presumably, if the holding company refuses in the first instance to avail itself of the opportunity to nominate the principal system which it prefers to retain, the Commission would then make the designation.

Let us examine the ABC standards relating to the retention of integrated systems in addition to the principal system.

(A) provides --

"Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

(B) (commonly called Big B) provides --

"All of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country;

(C) provides --

"The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advangages of localized management, efficient operation, or the effectiveness of regulation."

Argument concerning the proper construction of the A, B, C standards has heretofore centered about "Big B". Of the various interpretations that have been advanced, two have been fully argued before the Commission. The first, the so-called two-area interpretation, is that all additional systems which may be retained must be located in one state or in states adjoining each other, but such state or states need not adjoin the state or states in which the principal system is located. Under the second, the so-called one-area interpretation, all additional systems must be located in the same state as the principal system, or in states adjoining that state, or in a contiguous foreign country. In the case of *Engineers Public Service Company*, Holding Company Act Release No. 2897, decided in July of this year, the Commission passed upon this question and adopted the one-area interpretation. This was a job of construction. The Commission rejected the two-area interpretation as inconsistent with the purposes of the Act and found that the one-area interpretation accords with the legislative intent and the provisions of the Act. A practical consequence of this interpretation has been to achieve a very substantial delimitation of the properties which may be retained within the existing holding company systems, without the necessity of deciding issues which might otherwise arise under clause (A) as to whether or not the retention of control by the holding company of a particular additional system results in substantial economies which would be lost if such additional system were operated as an independent system, or under clause (C) as to whether the continued combination of such systems under the control of one holding company is not so large as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.

At the meeting of the Public Utility Law Section of the American Bar Association recently held in Indianapolis it was claimed by one speaker whose firm represents one of the largest holding companies that the Commission's interpretation of "Big B" was contrary to the plain language of the Act. A few days later in arguing the *United Corporation* case before us its counsel urged the Commission to disregard the literal language of the Act and construe it according to the Congressional intent. Thus everything depends upon what you want. It is my expectation that the counsel for each holding company system will contend for the interpretation which will allow his client to retain the most. So we find some of our legal brethren contending that theirs is the broad construction and ours the narrow. Yet if you lawyers will examine the reasoning in the *Engineers* case as disinterested lawyers I think you will find not that it is broad or narrow but that it is sensible. Some of the results which might follow from the so-called broad interpretation are described in the *Engineers* case. I do not think it is an overstatement to say that some of them would be rather ridiculous. The so-called broad interpretation would make the Connecticut Light & Power Company eligible for retention by United Gas Improvement Company so far as "Big B" is concerned but might have made ineligible the Luzerne County Gas & Electric Company located in Pennsylvania where United Gas Improvement Company's principal system is located. This is of course on the assumption that Luzerne is not part of the principal system as argued by United Gas Improvement, a point on which I express no opinion.

I know of no way we can administer statutes without having an opinion as to what they mean -- in other words, without construing them. When we construe them to counsel's liking, we are constructive public servants; when to their dislike, we are bureaucrats -- just as to some of us, due process is procedure we like, while red tape is procedure we dislike. Some of my friends in the utility business have called me one of the Pennsylvania Avenue Bureaucrats. I shall not retaliate by even suggesting that there are bureaucracies within any of our large holding companies.

You will note that the limitation of clause (C) of Section 11 (b) (1) affecting the permissiboe size of the combination of systems under the control of one holding company is expressed in language which is substantially identical with the parallel limitation contained in the definition in Section 2 (a) (29) of an "integrated public-utility system".

In this connection let me emphasize that the particular mode of doing business adopted by individual holding company systems is not significant in determining whether the size standard is exceeded. The test of the statute is whether by reason of size, considering of course the state of the art and the particular area or region affected, there is likely to be an impairment of the advantages of localized management, efficient operation and effective regulation.

Up to the present time few decisions construing these provisions relating to size limitation have been rendered. In the *Engineers Public Service Company* decision the Commission concluded that the electric property of Virginia Electric and Power Company, a company operating in large areas in

Virginia and North Carolina and having annual gross revenues of about $21,000,000, meets the standard of Section 2 (a) (29). It concluded in the same case that the electric property of Gulf States Utilities Company, a company operating in a large area in Texas and Louisiana, with annual gross revenues of approximately $10,000,000, also meets this standard. On the other hand, with respect to the southern group of properties controlled by The Commonwealth & Southern Corporation, the Commission has tentatively suggested that each of the state-wide areas under the control of Alabama Power Company or Georgia Power Company either exceeds or in any event approaches the maximum permissible size. The electric revenues of Alabama Power Company aggregate approximately $23,500,000; those of Georgia Power Company about $29,000,000. With respect to each of these companies, the Commission tentatively suggested that it might be difficult to find that management could be localized or that regulation could be effective over companies which dominate whole states. A similar tentative view was expressed by the Commission with respect to the property of Consumers Power Company located in Michigan. Let me emphasize that these ideas were expressed by the Commission in tentative form at the request of the companies concerned; they are of course subject to complete modification after the hearings are completed.

The Commission has also stated its opinion that the statute means that a "single integrated system" can include only electric or gas operations, not both. 1/ Accordingly, a holding company system can comprise both gas and electric operations only when it is proved that the ABC standards with respect to the retention of additional systems are satisfied.

1/ *Columbia Gas & Electric Corporation*, Holding Company Act Release No. 2477 (January 10, 1941); *The United Gas Improvement Company*, Holding Company Act Release No. 2692, Appendix G (April 15, 1941).

The remaining problem of interpretation of Section 11 (b)(1) to which I should like to call your attention is presented by the two "other business" clauses. The first of these clauses is found in that portion of 11 (b)(1) which limits the operations of the holding-company system (1) to a "single integrated public-utility system" and (2) to such other businesses "as are reasonably incidental, or economically necessary or appropriate" to the operations of the single integrated system. To this point, the Act contains no further definition or guide as to what businesses are or would be reasonably incidental, or economically necessary or appropriate to the operations of an integrated public-utility system. But, immediately following the ABC provisions relating to the retention of additional systems we find a second other business clause in the following language:

> "The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems."

In the case of *The United Gas Improvement Company* (Holding Company Act Release No. 2692, April 15, 1941) the Commission rejected the contention that the "other business" clauses refer only to non-utility subsidiaries and that investment interests (insufficient to create the statutory parent-subsidiary relationship) in both utilities and non-utilities are beyond the scope of any of the provisions of Section 11 (b)(1) and may be retained as a matter of course. The Commission concluded that the two clauses, when taken together, mean (1) that interests in non-utilities, whether or not sufficient to create the statutory parent-subsidiary relationship, may be retained only if their retention is found to

be necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems and (2) that an investment interest in a non-subsidiary utility company is retainable if the standards of the first "other business" clause are met. Some rather interesting claims and thoughts are advanced at variance with the interpretation. It is argued that the last sentence of Section 11 (b)(1) defines the language used in the first "other business" clause. It is true that Congress did not say, as it might have done: The words "such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations" of one or more integrated public-utility systems "are hereby defined to mean", etc. But, it is argued, what it said in the last sentence of 11 (b)(1) is the equivalent thereof and the last sentence of 11 (b)(1) expressly excludes the business of a public-utility company from the "other businesses" in which an interest may be retained. Those who argue this, conclude that Section 11 (b)(1) requires the divestiture of all interest in a public-utility company which is not a part of the principal integrated system or of such additional system or systems as may meet the ABC standards. They derive this conclusion from the fact that in setting up a guide as to the other businesses which may be retained Congress expressly excluded the business of a public-utility company.

Putting all this together, those supporting the view mentioned paraphrase Section 11 (b)(1) as follows:

The Commission, through requiring appropriate action by the holding company and every subsidiary thereof, shall limit operations of the system to a single integrated public-utility system and such additional integrated systems as may satisfy the ABC standards and to such other businesses, except the business of a public-utility company, the retention of which is found necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.

This construction of Section 11 (b) (1), it is argued, is consistent with Section 10 (c) which provides:

> . . . "The Commission shall not approve -- "(1) an acquisition of securities or utility assets, or of any other interest, which is unlawful under the provisions of Section 8 or is detrimental to the carrying out of the provisions of Section 11; or
>
> "(2) the acquisition of securities or utility assets of a public-utility or holding company unless the Commission finds that such acquisition will serve the public interest by tending towards the economical and efficient development of an integrated public-utility system."

Under Section 10 (c) (2), no acquisition, however small, of securities of a public utility or holding company can be approved unless we make the affirmative finding that such acquisition tends towards the economical and efficient development of an integrated public utility system. Under Section 10 (c) (1), which relates to an acquisition of securities of companies other than public utility or holding companies no such affirmative finding is required. The test here is: Will such acquisition be detrimental to the carrying out of the provisions of Section 11? It will be noted that the 10 (c) (1) standard for the acquisition of non-utility interests, although it ties into Section 11, is easier to satisfy than the test provided in Section 10 (c) (2) for the acquisition of interests in utility companies.

It is argued that the standard for determining whether the retention of utility interests should be permitted ought to be consistent with the standard for determining whether an acquisition of utility interests should be approved and it is claimed that the construction of Section 11 (b) (1) which I have described makes the two consistent.

A construction of Section 11 (b) (1) which would permit the retention of an interest in a non-system public utility company or holding company might place us in the peculiar position of approving the retention of a non-system utility interest even though we would be required by Section 10 (c) (2) to disapprove an application for the acquisition of that same interest.

The opponents of the idea argue that the standard for determining whether securities of a public utility or holding company may be retained may be different from the criterion used in determining whether such securities may be acquired. But the proponents reply that it was intended that the standard for retention be different from the standard for acquiring the same thing, one would expect to find the difference plainly spelled out in the Act. Furthermore, they say, since the retention provisions of Section 11 (b) (1) follow immediately after the acquisition provisions of Section 10, there is a presumption that similar language in the two sections should be given a similar interpretation, unless the basis for a different interpretation is clearly set forth. They find no basis in the language of the statute for any such differing interpretations.

As important as the size limiting aspects of Section 11 (b)(1), and perhaps more so, is the fact that compliance, in many instances, results in restoring independent status to the operating companies. As you know, the Holding Company Act does not regulate operating utility companies except where they are subsidiaries of registered holding companies and then not in all respects, e.g., as to rates. When an operating public utility company is freed from holding company control, it is subject only to State and local regulation and (as to certain interstate transactions) to regulation by the Federal Power Commission.

This seems to suggest that the Pennsylvania Ave. bureaucrats may be working themselves out of a job. Seriously, however, it is true some of our successful 11 (b)(1) efforts move the operating company involved out from under our jurisdiction and restores it to the jurisdiction of the State commission. Some writers on the Act have referred to this as a joker in the Act. But far from being a joker that is what Congress intended. The Act says so. The debates say so. Some of tne writers have just discovered it. The joker is in their failure to discover it earlier.

Incidentally, the responsibility that is then placed on local management and especially the local regulatory commissions is a very heavy one. Wherever Section 11 has the effect described it is extremely important that the operating company and the local regulatory bodies do a first class job. Otherwise, a strong movement may develop either toward a restoration of federal regulation or, what is more likely, toward public ownership.

It may be appropriate to mention several specific cases in which the operation of the Holding Company Act has resulted in restoring independent status to operating companies.

One of these is Indianapolis Power & Light Company, an operating utility serving the City of Indianapolis. This company was a subsidiary of Utilities Power & Light Corporation, a holding company which controlled utility properties scattered throughout the United States and Canada in places as far distant from each other as Nebraska, Connecticut and Nova Scotia. The holding company was in reorganization in the bankruptcy court under Section 77B. With the approval of the bankruptcy court the Trustee in bankruptcy, through underwriters, sold all the common stock of Indianapolis Power & Light Company. As a result of the sale, Indianapolis Power & Light Company is no longer a part of any holding company system. It is therefore not subject to regulation under the Holding Company Act, and conducts its business as an independent operating utility subject to appropriate State and local regulation.

Another instance is the disposition by The United Gas Improvement Company of its interest in Connecticut Light & Power Company. The United Gas Improvement Company is a large holding company system with its principal operations located in and around Philadelphia, Pennsylvania. In addition, however, it controlled various properties scattered in other parts of the United States, among which was that of Connecticut Light & Power Company, an operating company serving substantial areas in Connecticut. The United Gas Improvement Company sold to the public through underwriters its common stock holdings in Connecticut Light & Power Company. There are several similar instances which I need not detail.

Incidentally, I cannot recall a case of an unsuccessful effort to market common stock of an operating company. I cannot recall any case in which the holding company selling its holdings of the subsidiary's common stock suffered a substantial loss. I know of several in which there was a substantial gain. In one case now being studied by a holding company management, the chief obstacle to the sale of the stock of an operating subsidiary is the fear of a heavy tax liability on the large profit that the holding company would make. Contrary to the dire predictions so often made, there has been no deluge of common stocks of operating companies. There has been a trickle. But it is a fairly constant trickle and it is getting results. After us, and while we are on the job, there will be no deluge.

In other instances, the Commission has ordered disposition of interests in particular subsidiaries but the dispositions have not yet been completed. Proceedings are pending under Section 11 (b) (1) with respect to the holding company system of Engineers Public Service Company. This holding company now controls utility properties scattered throughout the United States, from Virginia, Florida and Georgia in the east, to Washington, New Mexico and Texas in the west. In the pending proceedings the Commission has already ordered disposition of the Puget Sound Power & Light Company property, located in the State of Washington, and The Key West Electric Company property located in Florida. Questions involving other utility properties remain for further consideration. The order directing disposition of the Puget Sound and The Key West properties does not specify the manner in which such disposition shall be made. These properties can be acquired by

other holding company systems only if their acquisition will serve the public interest by tending towards the economical and efficient development of an integrated public-utility system. If the properties are not acquired by holding company systems or if they are not acquired by public agencies, they will then become independent companies, subject to appropriate state or local regulation.

A second method for the disposition of operating subsidiaries when their divestment is required by Section 11 (b) (1) is the device of exchange of securities. In the case of Standard Gas and Electric Company, exchanges of San Diego Gas and Electric common stock for Standard's debentures, followed by a subsequent public sale of the stock not so exchanged, were employed successfully. San Diego was a subsidiary of Standard Gas, a large holding company controlling properties scattered from Pennsylvania to Oregon. The capital structure of Standard Gas is top-heavy with debt and other senior securities. The directors of the holding company recognized that substantial action had to be taken to comply with the simplification requirements of the law. As a step in that direction, they proposed a plan under which debenture holders of the holding company were offered the privilege of exchanging their debentures for common stock of the San Diego company. A substantial amount of the stock was distributed in exchange for debentures. The remainder of Standard's holdings of San Diego stock was publicly sold through underwriters. The effect of the transaction was twofold: As to the holding company, it eliminated an outlying property which had to be disposed of under Section 11, and it retired

substantial amounts of holding company debt; as to the operating company, it eliminated holding company control.

Exchange plans, whereby holding company security holders receive for their securities operating company common stocks, constitute an economical method of complying with the requirements of Section 11. Through such exchange plans, the common stocks of the non-retainable operating companies may serve to satisfy claims of senior security holders of the holding company with little, if any, shrinkage in the conversion process. The advantages of the exchange method accrue both to the holding company's common stockholders and the senior security holders. In the case of the common stockholder, the economy of the exchange device as contrasted with more costly methods are especially advantageous to the common stockholder by virtue of his residual position. The exchange process, moreover, gives the senior security holders an opportunity to acquire a direct interest in the operating companies in place of an indirect interest and at the same time it saves them the sometimes difficult problem of seeking a fresh outlet for their funds.

I do not want to create the impression that the exchange process is without its difficulties. For both the holding company and the Commission must carefully weigh the fairness of each exchange offer.

I move on now to Section 11 (b) (2) which deals with simplification and with the equitable distribution of voting rights. I have heard very little criticism of Section 11 (b) (2) from the holding companies. That section and the concomitant Section 11 (e) will give rise to some of the most novel and difficult problems under the Act. Section 11 (b) (2) reads as follows:

> "(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

"(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding compa company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company."

In substance, Section 11 (b) (2) requires the simplification of holding company systems, the elimination of superfluous holding companies and the fair and equitable distribution of voting power among security holders of holding company systems. The provision of this section dealing with the number of permissible layers of holding companies is known as "the great-grandfather clause". Its impact will be on those systems with more than two layers of holding companies above the operating companies.

It will be noted that the Commission is not authorized to require changes in the corporate structure or existence of an operating company except for the purpose of fairly and equitably distributing voting power among security holders. But the meaning of this limitation may be illuminated if we restate it in reverse form -- i.e.: Changes in the corporate structure of operating companies may be required if such changes are needed to achieve a fair and equitable distribution of voting rights. The Commission's experience reveals that in many cases a fair and equitable distribution of voting power cannot be achieved without making drastic changes in the corporate structure of individual operating companies. For example, if the amount of debt securities outstanding

is unduly large, there are likely to be conflicting interests between the persons who hold the voting securities and the senior security holders who have prior claims on the company's assets and earnings. If such prior rights are jeopardized by an unsound capital structure, it may be unfair and inequitable to the senior security holders to leave unchanged a distribution of voting power which enables the junior security holders to retain control.

While we have not as yet had extensive experience with the application of the equitable distribution of voting power standards, our present experience indicates that whereever the common stock equity is so thin as to make it inequitable for the common stockholders to continue to exercise voting control, the appropriate remedy under the Act is likely to be a substantial scaling down of the senior securities with a view to creating a corporate structure wherein the common stock equity is so substantial as to justify exercise of voting control by the holders of that common stock.

The theoretically possible alternative of shifting voting control to the senior security holders, but leaving the existing capitalization unchanged, involves all sorts of practical difficulties. Among others, there is the problem of reconciling the conflicting interest in managerial policies on the part of holders of junior and senior securities. This familiar problem of corporate finance has created difficulties even with the conventional arrangement which leaves the powers and responsibilities of management to the junior security holders. This conventional distribution of voting power assumes that the self interest of the common stockholders will, by and large, prompt managerial policies designed to promote the welfare of the senior security holders as well. We all know that this assumption has its limitations even where the common stock represents a substantial equity and that it completely broke down with the development of the holding company and of the pyramiding

process which made possible the control of the operating companies on the basis of a very limited investment. But, the transfer of voting control to the senior security holders does not seem to be the appropriate solution. In addition to the difficulty of protecting any genuine equity which may belong to the common stockholders, such a reversal of the traditional distribution of voting power would itself result in undue complexity and might interfere with the raising of new capital.

Since any action taken under Section 11 (b) (2) must be consistent with the standards set forth in the other provisions of the Act, the action which the Commission may require either for the purpose of corporate simplification or of equitably distributing voting power is likely, at the same time, to correct undue complexities which obstruct the raising of additional capital. An important barrier to the raising of new capital in the utility industry has been the existence of substantial arrearages of preferred stock dividends in many holding company systems. In addition there are more than a few instances where the controlling equity interest is so thin that further financing is precluded unless and until the security structure is revamped.

The relationship between the administration of Section 11 (b) (2) and the removal of impediments to the raising of new capital for operating companies is emphasized by the increased demand for power arising from the defense program with its need for rapid expansion of electric plan facilities.

To illustrate what I have in mind, let me describe to you what was accomplished in connection with two recent applications for the approval of financing programs by operating company subsidiaries. Although these applications were filed under other sections of the Act, the standards which have to be met pursuant to those sections tie in with the standards of Section 11.

Recently two operating companies, both of them in the same holding company system and both serving vital defense areas, sought the approval of the Commission for bond issues, the proceeds to be used for financing extensive construction programs consisting in large part of national defense projects. After examining the proposals, it appeared to the Commission's staff that the proposed financing plans did not meet the applicable requirements of the Act which prohibit the issuance of securities on the basis of fictitious values and issuances which are not reasonably adapted to the security structure, earning power and efficient operation of the issuing company. As a result of discussions with the Commission's staff, the companies revised their financing programs. Under the revised program for each company, the original proposed indebtedness was materially reduced as a result of additional common stock investments by the holding company through the payment of cash and the surrender for cancellation of bonds and preferred stock of the respective operating companies and through provision for raising a portion of the necessary cash from earnings over a three year period. The companies also agreed to eliminate large inflationary items in their property accounts, to increase their depreciation reserves to a more adequate amount, and to make

various changes in their financial statements so as to conform to sound accounting practice. In each case there was a public offering of 3-1/8% bonds resulting in a substantial interest saving both as to new money and as to the refunding of outstanding debt. Each company not only obtained the money necessary for new construction but in addition was able to improve its security structure. This improvement strengthens the position of their security holders and facilitates the raising of additional capital in the future.

In the case of one of these companies, over $10,000,000 of write-up was eliminated from the gross property account which approximated $18,000,000; the depreciation reserve was increased from $240,000 to $980,000 and the holding company invested an additional amount of approximately $2,000,000 in the company's common stock. This $2,000,000 investment was made through a cash payment of $250,000 and the surrender for cancellation of outstanding bonds, unsecured indebtedness and preferred stock. The amount of the proposed issuance of additional debt was reduced from $3,600,000 to $3,100,000 and a cash sinking fund to retire 1% of the new bonds annually and other protective features were provided. Similar constructive changes were made in the program of the second company.

After inviting competitive bids for the bond issues, pursuant to Rule U-50, the companies obtained their money at the low cost of approximately 3%, with a spread on resale to the public of less than one point in the case of one company and less than one-half point in the other. In comparison with minimum spreads of one and a half and two points which have been customary in the past, this represents a substantial saving to investors.

The result of the various adjustments was to establish a sound financial structure for each company. The fact that the companies were able to obtain the needed funds on a very favorable basis is attributable in a very large measure to this improvement in their financial position. It happens that no State regulatory authority has broad jurisdiction over either of these companies. In the absence of regulation under the Holding Company Act, unsound capital structures might have been perpetuated, to the detriment of the interests of investors and consumers. Moreover, the public interest would have been impaired through the inability of the companies to finance efficiently and soundly the extensive construction programs necessitated by national defense needs.

The practising lawyer will note that Section 11 (b) ends with the words: "Any order under this subsection shall be subject to judicial review as provided in Section 24." Such judicial review may be had by filing a petition for review in the Circuit Court of Appeals within sixty days after entry of the Commission's order. However, the respondent is entitled to a year's time in which to comply with an 11 (b) order and to an additional year if it is shown that such extension is necessary or appropriate in the public interest or for the protection of investors or consumers (Section 11 (c)). Even then, we may exercise our discretion not to apply to a Court for enforcement of our order if the company is doing its best to comply under the circumstances then existing and if the management has steam up and smoke is coming out of the chimney. And a very practical question which the practising lawyer ought to appreciate will be: Is the Commission likely to get better results from the standpoint of compliance with the Act by working with

the management or by working with a receiver or trustee? The procedure for enforcement by the Commission of its order under 11 (b) is by application to a district court (Sections 11 (d) and 18 (f)). Since judicial review is had in the Circuit Court of Appeals, whereas the application for enforcement is heard in the district court, the question has been asked: Is the respondent in an 11 (d) enforcement proceeding prevented from attacking the Commission's order if it has failed to seek the review permitted by the Act? However, this question seems largely academic since in the usual case the Circuit Court of Appeals will have issued its decision before the year or more for compliance provided by Section 11 (c) has elapsed. It seems safe to assume, therefore, that in those cases where a respondent intends to oppose the Commission's application for enforcement, the principal defenses available to it will have been passed upon by the Circuit Court of Appeals.

In the enforcement proceedings the court acts as a court of equity. It may take possession of the companies and their assets and it may appoint a trustee. To date no such appointment has been made or requested. The trustee with the approval of the court may dispose of any or all of the assets and may make such disposition in accordance with a "fair and equitable reorganization plan" which shall have been approved by the Commission after opportunity for hearing. The reorganization plan may be proposed in the first instance by the Commission or by any person having a bona fide interest in the reorganization.

Under Section 11 (e) a company may voluntarily submit a plan to the Commission for the purpose of enabling such company to comply with the provisions of Sections 11 (b) (1) and (2). *Inter Alia*, the section authorizes the submission of plans for voluntary reorganization. So far as the express language discloses, such plan may be submitted by a perfectly solvent corporation. An interesting bit of history in connection with this subsection is that it was made part of the Act largely at the instance of the holding companies, particularly the New England Power Association.

The Commission, before it approves a plan for voluntary reorganization submitted to it under Section 11 must find (1) (after notice and opportunity for hearing to security holders and others having legitimate interests) that the plan is necessary to effectuate the provisions of Section 11 (b), and (2) that the plan is "fair and equitable to the persons affected by such plan". If the plan is approved by the Commission, the company may request the Commission to apply to a district court to enforce the plan. If the court, in turn, approves the plan as fair and equitable and as appropriate to effectuate the provisions of Section 11, it may take possession of the company's assets and may appoint a trustee to administer the assets under the direction of the court. It will be noted that by virtue of Section 11 (d) the "fair and equitable" standard applies both to plans submitted voluntarily under Section 11 (e) and to plans for the disposition of assets resulting from proceedings instituted by the Commission under Section 11 (b).

It seems fairly clear from the decision of the Supreme Court in *Case v. Los Angeles Lumber Products Company, Ltd.* (308 U. S. 106) that the words "fair and equitable" are words of art and that they have the meaning imparted to them by judicial decisions. In other words, whether a plan submitted under Section 11 is fair and equitable is a question of law to be determined in accordance with the priorities test announced by the Supreme Court in a line of cases beginning with the *Boyd* case (228 U. S. 482) and continuing with the *Los Angeles Lumber* case, the *Deep Rock* case (*Taylor* v. *Standard Gas and Electric Company*, 306 U. S. 307), and *Consolidated Rock Products Co.* v. *DuBois* (312 U. S. 510). In the most recent of these cases, the *Consolidated Rock* case, the Court enunciated the principle that the absolute priority rule applies to reorganization of solvent as well as insolvent corporations.

We have approved a number of voluntary plans submitted under Section 11 (e). For the purpose of illustration, I will describe briefly the reorganization of *Community Power & Light Company*, a registered holding company (6 SEC 182). Community's capital structure consisted of $14,000,000 of bonds, preferred stock with a stated value of $6,896,000, so-called "assignments and agreements" in the amount of $370,000, and 10,000 shares of common stock whose value was stated to be $2,500,000. The arrears of dividends on the preferred stock amounted to $3,172,000 or approximately eight times the annual preferred stock dividend requirements.

The company proposed a plan to simplify this unsound structure and to remedy the inequitable distribution of voting power which existed. The plan provided for the creation of a single class of common stock entitled to one vote per share in substitution for the two classes of stock then existing. Each share of preferred stock, together with all accumulated and unpaid dividends, was to be exchanged for five shares of the new common stock. The preferred stockholders received in aggregate 344,810 shares of the new common, the remainder (18,000 shares) going to the old common. Since each share of new common stock was entitled to one vote, control of the company thus was lodged in the former preferred stockholders. The plan also provided for modifications of the so-called "assignments and agreements" so that they might be promptly retired by cash payment. The plan by its terms required the approval of two-thirds of the holders of preferred stock and the majority of the common. The plan provided no rights for dissenters except to receive the securities contemplated by the plan. This plan was approved in the first instance by the Commission and thereafter by a federal district court (*In re Community Power & Light Co.*, 33 Fed. Sup. 901). There was no appeal.

An interesting case in which I differed from the majority of the Commission as to the scope of the application of the priority doctrine to the particular facts is the case of *Federal Water Service Corporation* (Holding Company Releases Nos. 2635 and 3023). In that case the plan was submitted to the Commission upon an application under sections of the Act relating to the issuance and acquisition of securities. The company did not rely upon the machinery of Section 11 (e) and apparently it did not contemplate requesting the Commission to apply to the court for enforcement of the plan.

However, the entire Commission agreed that the plan must be "fair and equitable to the persons affected"; that is, that the plan had to be tested in the light of the standards of Section 11 (e). The company had an exceedingly complex capital structure consisting of $5,222,000 of debentures, four different series of preferred stock each with different dividend rates, and finally Class A and Class B common stocks. The Class A stock had priority as to assets in earnings over the Class B stock. There were substantial arrears of dividends on the preferred stock and deficits in the earned surplus and capital surplus accounts. In addition, it was admitted that the corporation's assets were carried at sums considerably in excess of their actual value and that these assets had to be written down. After deducting the $5,220,000 of debentures from the pro forma net assets, only about $15,000,000 would be left with which to satisfy preferred stock claims of approximately $25,000,000 computed at liquidating value plus arrearages.

The plan did not affect the debentures but substituted a single class of common stock and allocated approximately 95% of this stock among the four series of preferred stock and the remaining 5% to the Class A stockholders.

The Commission unanimously concluded that the Class B stock was not entitled to participate since there were nearly $54,000,000 of asset preferences ahead of the Class B as against pro forma assets of less than one-half that amount and since it was also clear that the Class B stock had no reasonable possibility of ever receiving anything from the corporation and that therefore it would be unfair and inequitable for the Class B to continue to enjoy any voting rights or to participate otherwise in the reorganized company. The Commission also unanimously disapproved a phase of the plan under which the Class B stockholders might have retained control

of the board of directors for almost two years after the consummation of the plan. However, the majority and I reached different conclusions on the question as to how the new common stock should be allocated among the different series of preferred stockholders. The majority concluded that an allotment of 5% of the common stock to the Class A stockholders was fair and equitable although it was apparently willing to assume that the Class A stock would not have been permitted to participate had the reorganization been brought under the Bankruptcy Act. My position was that there was no basis, under the applicable principles of law which I believed have been established by the courts, for the participation of the Class A stock, particularly since there was little hope for dividends on the Class A stock within any reasonably predictable future time and since, as I saw it, the preferred stockholders had not been made whole it was my opinion that the fair and equitable standard of Section 11 should be applied with the "fixed meaning" imparted to it by decisions of the Supreme Court under 77B and Chapter X of the Bankruptcy Act.

The Commission was unanimously of the view that the preferred stock, acquired by certain of the management during the period when the reorganization was being planned and set up, should not be allowed to participate in the new common on terms as favorable as those accorded the publicly-held preferred or any basis except a cost or no profit basis. The reasons for this view are spelled out in the opinion at some length and are accompanied by a discussion of many court precedents. Those of the management affected have appealed from the Commission's decision and apparently intend to attempt to confine the area of review to the one question of their participation. Whether they will succeed in this respect remains to be seen. In the meantime, the stockholders have approved the plan of reorganization by the requisite number of votes.

I also found difficulty with the allocation of new common to the various classes of preferred stock on the basis of the dividend rates rather than on the basis of their liquidating values.

To complete my discussion, I will make a few brief references to Sections 11 (f) and (g). Under 11 (f), the court may appoint the Commission as sole trustee or receiver in any proceeding in a federal court in which a receiver or trustee is appointed for a registered holding company or a subsidiary thereof. The Commission to date has not acted in either of these capacities. In the *Associated Gas & Electric* case a majority of the Commission voted that it would not accept the position of trustee were it invited to do so. Before it appoints a receiver or trustee other than the Commission, the court must notify the Commission and give it an opportunity to be heard. A plan for the reorganization of such a company cannot become effective unless the Commission has approved the plan after opportunity for hearing prior to its submission to the court. The plan may be proposed in the first instance by the Commission or by any person having a bona fide interest. The Commission may, by rules and regulations or order require that all fees and expenses in connection with a reorganization or liquidation of a registered holding company or subsidiary thereof shall be subject to approval by the Commission. The Commission does not exercise this power in those cases in which it has filed a notice of appearance pursuant to Section 208 of Chapter X of the Chandler Act (Rule U-63).

Section 11 (g) controls the solicitation of proxies, consents and similar documents in respect of any plan for the reorganization or dissolution of a registered holding company or subsidiary thereof. The solicitation must have been submitted to the Commission, unless the Commission itself proposed the plan and the solicitation must be accompanied by a report on the plan made by the Commission after opportunity for hearing or by an abstract of such a report. The solicitation must conform to our rules. These rules are designed to develop the truth and such of it as is material. Many investors seem to have found our reports helpful. We do our best to have them written simply. It is often very difficult to do so when the facts are numerous and complicated. To date the Commission has not in these reports advised the security holder how to vote. It does try to see that he gets all the pertinent truth so that he can exercise whatever powers of judgment he has on the basis of fact.

There in broad outline, with many important details necessarily omitted, is Section 11 of the Public Utility Holding Company Act of 1935.