LET
,3

Speeches. SEC staff

File

OPENING STATEMENT

by

COMMISSIONER ROBERT E. HEALY

of the

Securities and Exchange Commission

before the

COMMITTEE ON CORPORATE FINANCE

at the

1940 ANNUAL CONVENTION

NATIONAL ASSOCIATION OF RAILROAD AND UTILITIES COMMISSIONERS

Miami, Florida

2:00 P.M., December 12, 1940

41862

Mr. Chairman and Delegates:

In connection with this discussion of utility financing arise important matters dealing with relations and cooperation between state and federal agencies. So far as the federal side is concerned, I shall confine my remarks to the Securities and Exchange Commission and its duties and powers under the Public Utility Holding Company Act of 1935. Whenever a transaction or different aspects of the same transaction is subject to the jurisdiction of two agencies, there is always present the possibility of a difference of opinion which may be troublesome. The mere avoidance of embarrassment is by no means the major reason why the SEC and the state agencies should work harmoniously; the stubborn fact is that unless we cooperate fully, our common objective, viz., the regulation of public utilities in the public interest, will be endangered. It is our task to see to it that our respective spheres of jurisdiction are wholly occupied. There must be no void in which public utility activities go unregulated. To this end we must have an understanding knowledge of each other's activities. There may be some few in the utility ranks who would be glad to see a major conflict develop between state and federal regulators. Such a conflict would not be in the public interest, whatever may be said of private interests.

Wherein are the possibilities of conflict between the state public service commissions and the SEC? It does not lie in the field of rate making, as we have no jurisdiction in that field, although admittedly some of our attitudes might indirectly or remotely affect rates. In the field of accounting we have not attempted to promulgate a classification of accounts for operating utility subsidiaries of holding companies. So the

possibilities there are restricted to such accounting matters as grow out of the relations of operating companies to their controlling parent holding companies. Few prospects of trouble arise from our power to regulate holding companies, since it seems plain that such companies with their widely scattered subsidiaries outgrew the power of the states and that many of the difficulties of state regulation in the past twenty years grew out of practices imposed upon or fostered in operating companies by the controlling parent, the holding company. Certainly, adequate control of holding companies should, and I believe will, promote, simplify and supplement state regulation. The chance of conflict is not in the field of federal regulation of service companies, since here again operating companies were often victimized by companies beyond the jurisdiction of the state commission and, as has already been explained in the Report of the Special Committee on Uniform Service Contracts, of which Mr. Mahood is chairman, the fact that a service company has gained from the federal government the right to use the mails and facilities of interstate commerce does not in the least oust the state commission of its authority over the local operating company, or exempt the operating company in respect of its relations with the service company from the operation of state laws. It is not in connection with the acquisition of utility assets, for where such acquisition has been authorized by a state commission it is exempt from the necessity of our approval. The possibilities of a clash in all these respects are too remote and theoretical to merit further discussion in the limited time allotted me. These are where the possibilities do not exist. Where do they exist? Speaking generally, the possibilities of a clash between the respective jurisdictions of the

state and federal agencies usually arise in connection with (1) the issuance of new securities by public utility companies; (2) the sale or acquisition by a holding company of outstanding securities or properties of its operating subsidiaries; (3) mergers and consolidations, and (4) accounting entries incident to the foregoing. Because of the limited time, I have not found it possible to consider each of these separately, but I have consolidated them for the purpose of generalizing.

Under the Public Utility Holding Company Act of 1935, the issue and sale of securities by a registered public utility or subsidiaries of registered holding companies, comes before us either under Section 6 (b) or Section 7 of the Act. Our powers under these sections are quite different.

For our immediate purposes it is Section 6 (b) of the Act which is important. That section directs the SEC, subject to "such terms and conditions as it deems appropriate in the public interest or for the protection of investors or consumers", to exempt from the requirement of Section 7 of the Act an issue and sale of securities where (1) the issuer is a public utility company; (2) the issue and sale has been approved by a state commission of the state in which the issuer is both organized and doing business and (3) the issue and sale of the securities are solely for the purpose of financing the business of the issuer. Thus, where these requirements are met the SEC's affirmative power is limited to the imposition of "terms and conditions". It is only in the relatively few cases where these requirements are not present that we are required to measure an application to issue securities against the standards expressed in Section 7.

Section 6 (b) is the important section, for of the 47 states having commissions with power to regulate in one degree or another the activities of electric and gas utilities, 32 have express jurisdiction over security issues by such companies. These are among the larger states. Therefore, a majority of security issues by operating companies fall within the terms of this section. As a result many security issues of operating companies have been scrutinized by bodies before they are presented to us and our authority is limited to the imposition of "terms and conditions". Whatever the extent of that power may be, the Commission has imposed important restricting conditions in relatively few cases. In nearly every instance before imposing conditions, except those designed to insure compliance with the state commission's order, we have informed the state commission of our views and requested their comments. In some of these cases under this authority we have been able to impose conditions which the state commission had also thought necessary but was unable to impose because it lacked authority. A danger is that in some cases the state body, having authority, will fail to condition its approval because of a feeling that the SEC will do so. We, then, being ignorant of its motive, interpret its failure to attach the condition as an indication that the state body opposes it and thus hesitate, out of respect to the state body, to attach the condition. As a consequence, a condition necessary for the protection of investors might not be imposed. This could arise only out of a misunderstanding. If we were apprised of each others feelings this situation would not arise. Of course, I do not mean that if we conclude that a condition must be imposed for the benefit of investors or consumers that we ought not do so simply because the state commission

failed to impose a similar condition. We have an independent obligation in examining security issues to determine whether terms and conditions to the extent required by Section 6 (b) of the Act ought to be imposed.

I believe that when we meet a "tough" case -- especially one with novel problems -- much would be gained if the state and federal bodies were to consult on an informal basis. Then all of us would be advised of each other's impressions, of the extent of our powers and our purely tentative views as to what changes in the proposed transaction ought to be effected; then we would know the extent to which the state commission had examined into such matters as the property account, depreciation, fees and commissions, necessity for the financing, etc. I think too that the state bodies ought to recognize -- as I am sure they do -- the matters we must consider under the Holding Company Act. Though how far the state commissions may or should go in recognizing the provisions of this law is still in the area of uncertainty, I suggest that in passing upon a transaction, they might also consider that transaction from the standpoint of its impact upon the policy of the federal law therein expressed.

For example, where a public utility petitions a state body for approval to issue securities which it proposes to sell to its parent, a registered holding company, I think the state body ought to give consideration, to the extent of its statutory power, to the entire transaction, i.e., even if the proposed issue can be approved so far as the issuer is concerned, is it proper to permit it to sell these particular securities to its parent? I cite this example because it is indicative of the type of situation which often confronts us. A company proposes to issue securities

and sell them to its parent. It represents to us that the issue has been approved by the appropriate state commission. But we, under the Holding Company Act, must consider not alone the issuance of the securities by the operating company but also the acquisition by the parent holding company. So it may be that the acquisition of the particular security by the latter cannot be approved without a violation of our Act. Because a state commission is generally called upon to approve only the issuance of the security while the SEC is called upon to look at the acquisition of the securities by the holding company, different considerations enter into the deliberations of the two bodies. The acquisition aspect of the transactions merits our special attention because of the provisions of Section 11 and related sections and because of our program to build up equities and further because we are directed by the Act not to permit control of properties through disproportionately small investments.

An important aspect of financing cases is often the manner in which the incidental accounting entries are made. We have thus far exercised authority to prescribe accounting requirements only with respect to registered holding companies and subsidiary service companies. So far as operating utilities are concerned, the Act provides that we can only impose such accounting requirements as are not inconsistent with those prescribed by state and other federal agencies. But we may impose requirements which are additional thereto. We, however, have imposed no requirements. We have preferred to leave this matter to the state commissions and the Federal Power Commission. Our independent concern is with aspects over which the states do not have a direct concern, namely, the effect on the holding company's income and on the holding company's consolidated balance sheet

and profit and loss statement. Where we believed certain accounting entries to be questionable, we have taken up the matter with the state commission and expressed our views. There have been extremely few instances of this kind. We are encouraged to find the state bodies warmly receptive to this practice and so far our ideas have been in accord.

It is in connection with the sale by a holding company of outstanding equity securities of its subsidiaries that the need for cooperation appears to be even more necessary. Generally the sales of stock already outstanding do not require the approval of state regulatory bodies. In these cases we have some responsibility as to price. Yet, in the absence of state authority over the sale by the holding company, there is lacking an express or implied view of the state regulatory body as to future earnings prospects. But it is these earnings prospects which bear directly upon the common stock. Indeed, by reason of the fairly small proportion of the total assets often represented by common stock, the impact of rate changes upon common stock earnings is all the greater. If, shortly after the sale of these securities to the public, a drastic rate reduction should be ordered under such circumstances, there might be criticisms of the SEC for having permitted the sale of the securities by the holding company at the particular price. On the other hand, though the state commission may have nothing to do with the sale to the public of the particular securities, the effect of the rate reduction upon a price recently paid by public investors may have a considerable psychological influence and thereby act as a deterrent to a rate reduction that might otherwise be ordered. In this type of case we usually make it a condition of our order that the company agree that the price at which the securities are sold should not be used by it in any rate case or condemnation proceeding to indicate the value of its property.

The problem is indeed a delicate one and merits careful consideration. Very recently the SEC was confronted with just this kind of situation. We decided to confer informally with the state agency concerned and learned that the state body was not presently contemplating ordering any rate reductions and that it thought the proposed sale price quite fair. With this assurance, albeit informal, we went ahead and approved the sale. In this case the state body was glad to give the SEC the benefit of its views and the SEC was glad to get them. Informal consultation is not the only course open. The state commissions have the right to intervene as parties in proceedings before us involving companies in their jurisdictions. Whether the state commissions wish to accept any responsibility for the price at which holding companies are permitted to sell the public its portfolio holdings of operating companies is primarily a matter for the state commission's own determination. Either of these two methods, i.e., formal appearance and participation, or informal conference, appears to be satisfactory. Perhaps other methods will be found in the future to be more appropriate. In order that state commissions may be apprised of matters pending before us we have adopted the practice of sending notices of applications filed with us to the state commissions which have jurisdiction over the companies involved or which, for any reason, may have an interest in the proceeding.

I shall not deal separately with the problems presented in mergers and consolidations for I am sure you can recognize the similarity of problems that are likely there to arise with those which arise in connection with security issues and sales of outstanding stocks, though it is to be remembered that most of the reorganizations we deal with are those of holding companies.

An example of how much can be accomplished when the SEC and the state commission work together was recently illustrated in the proceeding which we conducted at the request of the Vermont Commission. This proceeding has been

referred to at length in the Report of the Special Committee on Uniform Service Contracts and therefore I need not consider the scope of this proceeding with you. Suffice it to say that I regard this proceeding as a convincing example of how effectively the SEC and state commission can -- and do -- cooperate. The Vermont Commission called upon us to conduct this investigation because it realized -- as Congress realized in giving us the authority -- that very often a federal agency with its larger staff and nationwide jurisdiction might be of assistance to the state commission in helping it enforce its own laws. Where the SEC is called upon to aid a state commission it does not in any way encroach upon state authority. The contrary is true. In this particular case the SEC conducted the investigation because the Vermont Commission concluded it needed aid to determine whether servicing arrangements between local utility companies and associate service companies organized beyond the boundaries of that state were in fact beneficial from the standpoint of service and reasonable from the standpoint of cost to the local companies. Such a determination necessarily required a study of records and related materials which generally are not available to the state commission except through the indulgence of the servicing company. These records can not be subpoenaed where they are located in other states. Though this proceeding was the first of its kind, we are hopeful that other state agencies will elect to make use of this statutory device to aid them in the enforcement of their own laws.

I shall not dwell any longer upon this matter. I referred to it only in an endeavor to point out to you how genuinely eager the SEC is to cooperate with and assist the state commission. The opportunities are many for it must be remembered that a service company which has complied with a federal statute and thus established its right to use the mails and the facilities of interstate commerce is not thereby excused from the obligation of complying with

state laws. The state commissions might well consider the advisability of intervening in the SEC proceedings on service companies. Though we always send notices of our hearings to interested state commissions, their interventions or even appearances have been few -- and in the case of service company proceedings there have been no interventions and only a very few appearances.

I want to impress upon you that our entire utility program is so designed that we may -- as we do -- work in close cooperation with the state commissions. Under the provisions of the Holding Company Act, state commissions have an express right to intervene in any SEC proceeding affecting them. The Holding Company Act, as much I think as any other federal act, contemplated federal-state cooperation. For example, in Section 18 (b) of the Act there is provided an over-all authorization for SEC-state commission cooperation. There it is said that the SEC upon the request of a state commission may "investigate, or obtain any information regarding the business, financial condition, or practices of any registered holding company or subsidiary company thereof or facts, conditions, practices or matters affecting the relations between any such company and any other company and companies in the same holding company system". We at the SEC are happy indeed to use our facilities to aid state commissions in carrying out their important duties in connection with the regulation of public utilities operating within their respective states. We hope that more and more the state commissions will call upon us for aid wherever, because of inadequate facilities and limited powers over extra-state matters, they find themselves handicapped. We, in turn, have similarly profited immeasurably from our close relations with the state commissions.

Whether you agree with all I have said or not, I do earnestly insist that we have no desire to encroach upon the powers of the state commissions. We do wish to support effective state regulation by taking the predatory

type of holding company and service company off the backs of the operating companies; to see to it that the control of operating companies within your states, if it must be continued in the hands of holding companies, will not so continue unless holding companies make actual and substantial contributions to the capital of its subsidiaries; that holding companies through manipulation will not acquire control of large amounts of securities of your operating companies at no cost or very little cost; that a nationwide system of private socialism will not be promoted through concentration of ownership and control of a great many operating companies in a few corporations. I question whether local regulation will always prosper under that kind of absentee landlordism. I do not believe that the federal government in exercising its constitutional powers over interstate commerce is acting as an absentee landlord. The federal government has its legitimate place in the utility regulatory effort. Everyone who has spoken in this convention has recognized this truth. I do agree that the federal government should keep its place and not encroach upon the power of the states. And above all, I do not want to give you the impression that we resent criticism. Unhappily, despite the best of intentions we undoubtedly contribute at least our share to the sum of human mistakes. It is desirable to have our mistakes pointed out to us. We shall accept fair criticism.

I have the deep conviction, as do my associate commissioners, that effective regulation of public utilities in the public interest will be furthered by a more extended cooperation between the SEC and the state commissions. The federal and state regulatory agencies have a common end, namely, the regulation of utilities in the interest of the public investors and consumers. We dare not be singularly jealous of our accomplishments and authority if the objective is to be attained. That objective can be reached if we work together.

---oOo---