BLUE-SKY REGULATION AND PUBLIC UTILITY SECURITIES

by

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Public utility operators in the section in convention here have practically all come in touch with public regulation during a period of fifteen or twenty years past. In more or less complete form, the states in which you operate have asserted their right to control such matters as rates to be charged and standards of service to be supplied. They have prescribed accounting standards to be followed and have imposed restrictions upon the issuance of utility securities. The industry, in the main, has adjusted itself to the conditions resulting from the exercise of the regulatory power of the states and not infrequently has been vigorous in resisting attempts to tear down the structure of state regulation or to impair its functioning either by reverting to municipal control or by centralization in the federal government.

The phase of public regulation which I am to discuss is of more recent development than the control over rates and service or over the issuance of securities, and involves the direct control by the states of the marketing and sale of such securities. In some form or other most of the states have enacted laws to control the sale of securities, with a view to preventing fraud and unfair practices. Industries such as those represented here, whose annual requirements for additional capital are measured in billions of dollars and which, for all practical purposes, are compelled to be constantly expanding cannot fail to be concerned with the exercise of governmental control over the marketing of their stocks and bonds. To assure the flow of capital to meet the imperative needs of the industry is one of the primary obligations of management. If the policy of the states, or ultimately of the nation, should be to impose restrictions which are well within the range of possibility, the power of utilities to command capital may be seriously impaired, and I think it is no exaggeration to say that if better standards are not provided—no matter by whom, the ultimate result may be injurious to utility credit.

What relationship is there, then, between blue-sky regulation and utility securities? The essential feature of blue-sky legislation is the intent to prevent fraud and unfair practices in the sale of securities. It is not the function of such legislation to protect the purchaser of securities against such danger of loss as may be inherent in the security which he buys. Neither is such legislation designed to prevent the purchaser from speculating if he desires to do so. It is designed to assure, as far as its adminis-

tration can accomplish the purpose, that the buyer of securities is not misled as to the real nature of what he buys, that where he is buying speculative securities he be sufficiently advised of that fact, and that he have in return for the risk which he assumes, a fair chance for speculative profit.

Blue-sky legislation is in a measure paternalistic but that paternalism is not intended to limit the individual in taking risks with his money. It protects him only to the extent that it interferes with the right of someone else to sell him securities which in themselves are fraudulent or unfair or to sell him any securities by fraudulent or unfair methods.

Obviously, then, if no utility securities are inherently unfair or fraudulent and if sales methods are always above reproach there is no problem for the securities department. Unfortunately, but inevitably, this ideal condition does not exist. Not all utility securities meet the standards of blue-sky legislation and sales methods range all the way from those of the highest standard, down through those which merely fail to give information which the prospective purchaser ought to have, to those which mislead by the use of fictitious valuations and improper statements of earnings.

Very generally the blue-sky laws exempt from their operation securities, whose issuance has been authorized by any public service commission and, to an extent which I know no way of measuring, the investing public assumes that such authorization carries with it an assurance of merit. However, many of the laws controlling the issuance of utility securities give the public service commissions substantially no power to deny a certificate because of unsoundness of the security to be issued, and in many states the commissions do not have adequate facilities for the determination of important facts. The result is that the number of commissions whose certificates may be accepted as any indication of merit or soundness is sharply limited. To the extent that such certificates are accepted as a basis for exempting the securities from sales regulation, the doctrine of state comity has been improperly invoked and the purpose of blue-sky regulation has been defeated. The security sales statutes, in this respect, fail to offer any substantial assurance that the securities themselves meet the standards set up for non-exempt issues.

For the most part, however, the administration of the blue-sky legislation in its relation to public utility securities, meets its most serious difficulty in connection with sales methods employed by distributing houses. I am not referring here primarily to high pressure sales methods or exaggerated representations of individual salesmen. These are individual manifestations which are not always easy to deal with but which, as far as my experience

indicates, are not particularly serious in connection with the sale of utility securities. The typical high-pressure salesman is not often encountered in this field.

From the standpoint of blue-sky law administration the objectionable sales practices appear rather to be matters of general sales policy, much harder to eradicate or control than the individual acts of an over zealous salesman. Some of these objectionable practices stop well short of the point where they could be held to be fraudulent or legally unfair. The Securities Commission of course can prohibit only such practises as a court would hold to constitute misrepresentative or misleading. Much of the information distributed on security issues may mislead the average investor though not reaching the point where an order of a securities commission refusing to permit its use could be enforced in court.

The Public Service Securities Committee of the Investment Bankers' Association seems to have recognized this situation and has formulated general standards regarding circulars on utility issues, which it may be assumed reflect the opinions of members of the committee as to the nature of the information which should be given. If we note the extent to which circulars used by its members fail to disclose the information recommended by its committee, it is easy to understand why the published proceedings of the conventions of the Association should contain a disclaimer of responsibility for or acceptance of opinions therein expressed.

A general statement made by the 1922 committee is of interest. That committee, referring to public utility companies, said, "We believe that any such company which seeks capital from the investing public should make available and readily accessible all information and data pertaining to both the holding company and subsidiaries necessary for a thorough study of earnings, expenses, maintenance expenditures or reserves, fixed charges, dividends, assets, capitalization and liabilities." It is hardly conceivable that a reputable banking house would handle an issue without having this information, but the circular which adequately conveys the information to the retail purchaser is almost the exception.

The 1928 committee listed a number of points on which circulars should inform the prospective buyer, and from this list I have selected only a few of the most important for discussion here. In order to determine some thing as to how the committee's recommendations were followed by distributing houses, I have had an analysis made of forty-one circulars on recent issues. No selective process was followed in choosing the circulars to be studied, except that a considerable number of large issues, with national distribution, was taken and also a number of small issues whose distribution was limited. The list includes issues handled

by some of the highest grade houses in the country and others of houses of lesser standing and poorer reputation.

The 1928 committee recommended that circulars should contain information regarding the valuation of the property and the basis of the valuation, but of the forty-one circulars analyzed twenty-eight were silent as to the valuation of the property. Less than a third of the circulars gave any information as to property values and, of these, two merely stated that the value was largely or substantially in excess of the funded debt. Thirteen circulars which gave information as to valuation gave the name of the appraiser and the list included some appraisers whose results we have found, in our own work of public utility regulation, to be so extreme that they could not be given any consideration whatever and which could not be supported either by the cost of reproducing the property or by its commercial possibilities. It is no secret that appraisal concerns have been subjected to great pressure by some dealers to secure high valuations and I have seen appraisal results of well known concerns which seemed to reflect this very plainly. Many dealers seem to feel that if they can get some well known appraiser to state a value their responsibility ceases, even though, if at all familiar with utility properties, they must know such value to be fanciful. It would be most unfair to leave the impression that the appraisals used are generally subject to this criticism, but the use of exaggerated values in some instances tends to cast doubt upon the correctness of values stated in other cases. With over two-thirds of the circulars making no showing as to values, the methods of selling utility securities seem to fall far short of compliance with the recommendation of the committee. Although satisfactory earnings are of vital importance to purchasers of utility securities, investors and dealers should not lose sight of the fact that, in a regulated business, the fair return which the business is entitled to earn is predicated on the value of the property, and present earnings, unrelated to property value, do not tell the whole story.

Another recommendation of the Investment Bankers' Association Committee, which has been ignored in many offerings, is that the circulars should contain a balance sheet of the issuer or a clear statement of capitalization. Of the circulars studied five made no reference whatever to the capital structure. Twenty-six circulars showed the number of shares of common stock but gave no information as to the amount invested in that stock or as to the value of the equity represented. Two offerings showed the number of shares with some reference to the amount of the equity but without definite information. Only eight of the circulars, or less than one-fifth, showed either the investment in the common stock or the value of the equity as measured by the market

price of the shares. It is superfluous to say that most of the circulars examined do not give the purchaser the information regarding capitalization which he needs if he is to form any intelligent opinion as to the position of the issue he is to purchase.

We must bear in mind that the number of purchasers of utility securities has been very much increased in the past few years; that many, and perhaps most, purchasers are not trained in analyzing statements made in circulars, and that the omission of important information or its statement in a form which is not clear and definite, is more likely to mislead than when sales are made only to experienced buyers, accustomed to analyzing financial statements.

A third recommendation of the committee which seems to have been ignored in most cases is that circulars should contain a statement of earnings, including the operating ratio, a statement as to depreciation, the ratio of net earnings to charges, and a statement of the issuer's dividend record. This amounts to a restatement of the recommendation of the 1922 committee that, sufficient information should be given for a thorough study of earnings, expenses, maintenance expenditures and reserves, fixed charges and dividends. Committee reports substantially similar to the 1922 and 1928 reports have been submitted in other years. One might expect to find the recommendations of these committees reflected in offering statements, even though in some cases the distributors are not members of the Investment Bankers' Association, but not only are the recommendations as to information regarding property valuations and capitalization not generally followed but in most of the circulars examined there is no adequate information as to earnings, operating expenses, maintenance expenditures and reserves.

Only six of the forty-one offerings showed anything definite as to the provision for depreciation or retirements. In four of these the amount was shown, for at least one year, and in two the provision could be ascertained from other language in the circular. Six circulars made no statement whatever of operating expenses and twenty-nine showed operating expenses, including maintenance and property taxes but made no showing as to depreciation or retirements. Those circulars which showed the total expenses before depreciation and federal taxes were not in agreement as to what the excess of revenues over such expenses should be called. About one-third of the circulars designated it "available for" depreciation, depletion, federal taxes and return, thus giving some recognition to the existence of these items of expense. In other cases this balance was called "net earnings from operation"; in a third of the cases it was called "net profit", which it clearly was not in most of the instances, and a few circulars referred to it only as a "balance". Those which referred to the

balance as the amount available for depreciation, depletion, federal taxes, etc., were probably technically correct although they failed to give any adequate information regarding the provision for reserves. Those which called this balance "net profit" or "net earnings from operation" came uncomfortably close to misrepresentation.

Without attempting to discuss the question of depreciation of utility property, over which many bitter controversies have been waged, it seems inescapable that the true profit or net earnings have not been stated unless there has been deducted an amount sufficient to accumulate that year's proportion of the reserve to cover retirement losses. The effect of such circulars is particularly vicious in telephone financing because of the comparatively short life of the property. Some recent telephone security circulars have shown apparently favorable ratios of earnings to bond interest requirements, where a full statement of the facts would show that the interest had not actually been earned if adequate provision for depreciation or retirements had been made.

In these various respects the methods of selling utility securities very often overstep the line of "unfairness" established by blue-sky legislation. If any of you are curious to investigate further how far many of the circulars fail to meet the standards of good practice recommended by the Investment Bankers' Association committee it will be interesting for you to compare any typical group of circulars with the recommendations of the 1928 and previous committees. I have attempted the comparison only in relation to three of the standards suggested by the committee.

There is one other characteristic of many of the circulars, especially those on weaker issues, which may, and I think often does, constitute an unfair sales practice. This is elimination of "non-recurring expenses". In some cases there is doubtless sufficient basis for some such elimination but generally it is impossible to forecast just what the expenses will be and the elimination merely becomes a convenient means of "sweetening up the picture". One conspicuous instance which comes to mind is that of a telephone consolidation where the expenses per telephone, before consolidation, were less than could possibly be continued if good service were to be furnished and proper maintenance standards met. Yet this issue was offered on a circular which claimed that a very material elimination of expenses could be secured. The claim of elimination of non-recurring expenses is a fairly sure indication of weakness and usually serves as a warning to blue-sky administrations to look farther for evidence of unsoundness of the issue and for unfair practices in its sale.

It seems to me that for purposes of this discussion we may treat of utility issues in two general classes. In one class are those

issues which are for refinancing and consolidation purposes and, in the other, those which provide capital for extensions of the system which will create additional revenues or lower the cost of operation. Often these classes overlap or merge. Where an issue is strictly for refinancing or consolidation purposes there may be great danger in sales representations which do not reflect the entire cost of doing the business, including the provision for reserves. Where the issue is to finance lines to produce additional revenue or improvements to decrease expenses the danger may be minimized because the improved earnings are likely to afford adequate protection, but incomplete or misleading statements in circulars are tinged with unfairness, nevertheless.

Blue-sky regulation is intended to prevent, not only the more palpable forms of fraud, but unfair and inequitable sales practices as well. The development of standards is slow and the definition of what constitutes unfair practice is evolving very gradually. Standards which are unnecessarily harsh and which would interfere with needed development would be unfortunate. We cannot, however, close our eyes to the fact that in many cases recent utility consolidations have not been the result of any logical development in the industry, related to improved efficiency or more adequate service. Increased marketing facilities, sterner competition in the securities business, and the popularity which the high standing of sound and seasoned issues has given to all utility securities, have resulted in consolidations of questionable economic or social advantage. Properties scattered throughout the country whose situation could not be improved by a common ownership have been picked up, financed on the basis of valuations which are too frequently unsound, and their securities sold on circulars that were not full and frank statements of their position. In some cases the new consolidations have no officers experienced in the utility business and no central organization capable of exercising effective supervision over the properties. Many of such consolidations have all the indications of having been made for the purpose of creating securities to be marketed. They are a menace to the credit of the utility business; they furnish grounds for criticism of a political nature, and they issue securities which are marketed, not so much on their own merits as on the strength of the standing of issues which have popularized utility investments. Not only the existing facilities and business have been mortgaged but the possibilities for years to come have been discounted. Blue-sky law administration should not interfere with legitimate financing, even though it be speculative, but it is intended to furnish some assurance to investors that what they buy is what they think they are buying, that speculative securities are sold as such, and that the methods of sale are fair. No exact standard of fairness can be fixed. What might be fair representations to an experienced banker

or to a utility operator may be entirely misleading to a great body of purchasers who lack experience and training in the analysis of financial statements and in the study of sales literature.

Whatever improvement can be secured by voluntary action of dealers' associations and by individual houses will help to solve the problems of blue-sky administration, by eliminating them. Where dealers and their associations fall short, those administering securities sales laws must act in accordance with their best judgment to secure fair dealing. Direct control of personal and printed representations is then inescapable.