BUREAU OF NATIONAL AFFAIRS, INC. - FEDERAL BAR ASSOCIATION
BRIEFING CONFERENCE ON SECURITIES LAWS AND REGULATION

Remarks of Robert A. McDowell

Friday afternoon, June 4, 1954

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Mr. Adams, and Ladies and Gentlemen:

Mr. Adams has already said that I do not profess to be an indenture expert. Let me emphasize that fact. There are many here today who have had far more experience both in drafting and in operating under utility trust indentures and preferred stock charter provisions than I have had. My background, however, is not confined to that of a regulatory official, and I can assure you all that I have suffered the late-night pangs of trying to express a thought -- which the regulatory authorities have said is simple -- in the concrete language of a trust indenture, and of trying to be sure, both for myself and my client, that in inserting this new thought, I have not upset an unsuspected but related part of the same instrument.

You have all seen our recent draft Statements of Policy with respect to indenture and preferred stock protective provision standards. We have worked hard on these Statements, and believe that they should be fair from the standpoint of all concerned. Fortunately, the staff and the Commission have had the able assistance of a lawyer with many years of experience in indenture drafting. The Statements, however, reflect not only his views, but also the combined efforts of the Commission's regular staff and, indeed, of various members of the Commission itself. Public comments can be made on the Statements of Policy up until June 30, 1954, after which the Commission will decide whether a public hearing seems advisable.

Mr. Adams has mentioned the philosophical problems which

exist under the Holding Company Act as to the Commission's authority to prescribe protective provision standards, and as to whether assuming we have such authority with respect to declarations under Section 7, wê also have it with respect to applications for exemption filed under Section 6(b). Under the negative standards of Section 7(d), which applies specifically to declarations, the Commission is required to permit a declaration regarding the issue and sale of a security to become effective unless it finds that the terms and conditions of the issue or sale are detrimental to the public interest or the interest of investors and consumers.

In considering an issue and sale, the Commission has, since the early days of the Holding Company Act, considered that it should examine, not only the purchase contract or underwriting agreement, and the bidding papers if competitive bidding is involved, but also the protective provisions of the corporate charter, or the trust indenture. In the early 1940's the Commission began to evolve standards against which it compared such charter provisions and indentures. These were flexible at first, because of the marked differences which existed from holding company system to holding company system, in the size and financial standing of systems, the number of layers of securities outstanding in the hands of public or private investors, the existent capitalization ratios, and a multitude of differences in previous drafting approach. Over the years, it became pretty well established that public utility holding companies and their subsidiaries should not be permitted to issue bonds in an amount exceeding 60% of the value of the bonded property and of property additions, that indentures should provide adequately for maintenance and replacement of the mortgaged

property, and should provide further for a sinking fund of at least 1% of the principal amount of the outstanding bonds. It further became established that preferred stock should be cumulative, freely callable upon reasonable notice, and that upon substantial default of dividends the preferred should be assured of control of the company.

Section 6(b) of the Act has already been referred to. Section 6(b) directs the Commission to exempt by rules, regulations or order, the issue or sale of any security by a subsidiary of a registered holding company if such issue and sale are for the purpose of financing the subsidiary's business and have been expressly authorized by the State Commission of the state in which the subsidiary is organized and doing business. There is an additional clause in Section 6(b), however, which says that the exemption will be granted, subject to such terms and conditions as the Commission deems appropriate in the public interest or for the protection of investors and consumers. In considering appropriate terms and conditions, the Commission has looked to the evils against which the Act was directed, as set forth in Section 1, and then has considered the so-called negative findings prescribed by Section 7(d), which I have already mentioned. In this way, the Commission has equated orders granting exemptions under Section 6(b) to the same standards -- insofar as protective provisions and manner of sale are concerned -- with orders declaring exemptions effective under Sections 6(a) and 7.

Through the 1940's and indeed almost until June 1953, it depended to a great extent on which organizational section in the Division of

Public Utilities was administering the affairs of a particular holding company system, just what additional standards were applied to the indentures and preferred stock charter provisions of the companies in that system. Certain section chiefs and their attorneys emphasized one point; other emphasized another. This was unsatisfactory. And in the winter of 1952-1953, under the leadership of Chairman Cook, extensive conferences were held at the staff level for the purpose of working out standards which could be applied on a more universal basis throughout the Division administering the Holding Company Act. These conferences eventually produced a set of written standards which were then the subject of extensive discussion with the full Commission. In June 1953 just before Chairman Demmler took office the Commission approved the standards which by then had been developed, to serve as a guide for the Division. The Commission Minute of that action directed the Division to report to the Commission any request by a particular company for deviation from the standards. The object was to have the Commission, rather than the staff, weigh the merits of arguments for and against the standards under the exigencies of a particular case and ultimately decide whether deviation would be permitted.

I might say that while there may have been some vagueness in the standards so far as the industry was concerned, it is a fact that the more important standards were outlined in the 13th Annual Report of the Commission to Congress in 1947.

Let me now proceed to a discussion of our Statements of Policy. You will note that our Statement of Policy about first mortgage bonds applies only to the first mortgage bonds of public utility companies. It does not apply to debenture indentures or collateral trust indentures of holding companies, except in the event the latter are combined with a first mortgage bond indenture of an operating company. This does not mean that we will not expect to examine these other indentures, but rather means simply that we do not intend by this Statement of Policy to announce any standards with respect to such instruments.

In reading the introductory material in the draft Statement of Policy, you will note that different treatment will be accorded to certain supplemental indentures than will be applied in the case of a brand-new first mortgage indenture. The Commission realizes that this is the only practical approach. It is unrealistic and would produce harsh results if the Statement of Policy was categorically applied to all subsequent series of bonds even though issued under an indenture which had in substance been previously approved by the Commission. There are presently some 58 first mortgage bond indentures of public utility companies subject to the Act. In all but 4 cases the bonds outstanding under these indentures are rated A or better by Moody. In these 4 remaining cases, the rating is Baa. In view of these factors we believe that in issuing additional series under an existing indenture, issuers should be free to proceed as they have in the past, and this in itself is, I believe, quite a new approach. It is subject to the one condition that the surplus freeze, and any covenants with respect thereto, will be carefully reexamined. The surplus freeze and the resulting dividend restriction will undoubtedly prove to be one of the most controversial parts of the Statement of Policy, and I will talk about it in more detail a little later.

Also, as stated in the introduction to the Statement of Policy, you will note that the Commission wants to find out whether the typical 15% of gross rêvenue provision, included as the so-called Maintenance

and Replacement Fund in many public utility first mortgage bond indentures today, is actually providing an adequate fund to take care of depreciation. This is the reason why the Commission is in suhstance requiring that before July 1, 1955, approximately one year from now, all companies subject to its jurisdiction submit studies which show whether or not such an existing provision is adequately providing for renewal and replacement based on the basis of actual experience. We have no pre-determined ideas as to what percentage of the book cost is the correct cost for an operating utility, and expect that the percentage will vary from company to company depending upon whether it is a gas distribution company, a hydro-electric company, a steam generating company, or a combination of these. The composite figure obviously will not necessarily be the same as the amount allowed under the tax laws as a depreciation deduction, nor will it necessarily be the same as the figure used for computing Profit and Loss and presented to the stockholders in public financial statements. These figures, however, will be taken into consideration in determining what is a reasonable annual requirement for replacement of the book cost of depreciable mortgaged property.

The Commission has consistently taken a position against non-redeemable debt securities, and the Statement of Policy includes a requirement that the bonds shall be callable, at any time upon reasonable notice and with reasonable redemption premiums. In this connection, I call your attention to the Arkansas-Louisiana Gas case, Holding Company Act Release No. 12134 decided by the Commission on July 14, 1953, and the Indiana and Michigan Electric case, Holding Company Act Release No. 12140

issued on September 21, 1953, in both of which a limitation on the right to call debt securities was permitted with extreme reluctance and with an indication that issuers would have a hard time obtaining such approval in the future. This also applies to preferred stocks.

The Statement of Policy provides that additional bonds may be issued under the indenture only to the extent of 60% of the bondable value of the net property additions, and only if earnings available for interest during the preceding one-year period have been equal to at least twice the annual interest requirements on all bonds outstanding and to be outstanding. The Statement of Policy calls for a 1% sinking fund which, however, can be met either with cash or by the deposit of bonds or by a certificate of property additions at 60% of the bondable value thereof. Property additions used for this purpose cannot be used as a basis for the issuance of additional bonds. As I have already noted, the amount of the so-called M & R Fund, or Maintenance andReplacement Fund, is determined on the basis of a percentage of the book cost, rather than on the basis of a percentage of gross operating revenues. Any deficiency in expenditures for this purpose must be met by the deposit of comprable cash with the trustee or the deposit of an equal amount of retired bonds.

The Statement of Policy includes a limitation on the right of the debtor to acquire property subject to a prior lien, but we

believe that this limitation is an entirely fair one. It does not prohibit, as some indentures do, the acquisition of property if the prior lien thereon is in an amount greater than 60% of the value of such property. Nor does it impose any earnings test. Instead, it provides in substance that property additions subject to a prior lien may be used as the basis for the issuance of additional bonds under the principal mortgage only after deducting prior lien bonds at the rate of 166-2/3% of the principal amount thereof. And, if property subject to a prior lien is used as a basis for issuing additional bonds under the principal mortgage, there is required to be deposited with the trustee under the principal mortgage, a principal amount of prior lien bonds not theretofore issued under the prior lien indenture at least equal to the principal amount of the additional bonds then being issued to the public under the principal indenture. There must be an absolute prohibition against issuance of prior lien bonds to the public. This is essential in order to diminish the creation of a divisional lien situation, which the Commission has historically opposed.

I turn now to our proposed standards in respect of a surplus freeze and dividend restrictions. It is proposed that in the case of an original indenture all surplus, except for one year's dividend requirements on the common and preferred, be frozen and thereby be made unavailable for distribution as a dividend on equity securities. This has been the pattern generally followed to date and is generally insisted upon by institutional investors. We see no reason why the same rule should not apply to

the issuance of an additional series under an existing indenture, although if the ratio of bonded debt to mortgaged property is particulary low, and the use of the surplus will not materially affect capitalization ratios, a free surplus balloon may be permitted in an amount greater than a one year's dividend requirements. We have struggled for a more definite formula in this area but after much discussion have about decided that to be more definite is to be impractical. The surplus freeze also requires that the indenture prohibit unfreezing, in the event of the subsequent sale of the equity securities, except to the extent of acquisitions of equity securities. For practical purposes, this means that frozen surplus cannot be unfrozen by the sale of stock. The theory behind this is that the bondholders are entitled to maintenance of their relative ratio position in the company, as distinguished from a fixed dollar cushion of equity under the bonds irrespective of growth. This theory certainly can be debated, and I can assure you has already been the subject of long debate by the staff and the Commission, but essentially we feel that if a surplus restriction is to be required at all it should have some teeth in it, and that to permit the unfreezing of surplus upon the sale of common stock -- which takes place almost annually in a period of expansion -- is to have no surplus restriction at all.

Our preferred stock Statement of Policy is easier to comprehend. Preferred stock must be cumulative, and it must be callable. It must have the right to elect a majority of the directors upon default in the payment of four full quarter yearly dividends. The issuance of

secured debt does not have to be restricted but unsecured debt cannot be issued in an amount exceeding 20% of existing secured debt plus capital stock and surplus, and even then, unsecured debt maturing within 10 years must be limited to 10% of such aggregate figure.

Dividends on common stock are limited by the so-called ABC test so that if common equity, which includes par or stated value of common stock plus earned surplus, exceeds 25% of total capitalization, there is no limitation; if it drops below 25% but not below 20%, there is a provision that only 75% of any income available for dividends on common stock can be declared out as dividends; and if it drops below 20%, there is a provision that only 50% of such net income can be paid out as dividends.

A two-thirds vote of the preferred is required in order adversely to change the preferred stock protective provisions, or authorize any prior preferred. A majority vote of the preferred must be obtained in order to carry out a merger or consolidation or sale of assets, and in order to issue additional shares of preferred ranking on a parity with outstanding shares unless, in the latter case, a specified gross income test is met (one and one-half times interest charges and preferred dividend requirements) and unless the junior equity is at least equal in amount to the preferred equity. The charter must prohibit the issuer from buying in its preferred stock if dividends are in arrears, unless approval is obtained under the Holding Company Act or unless all preferred stock is redeemed. Upon voluntary liquidation the holders of preferred must have the right to receive the then current redemption price, as distinguished from par value or some other figure.