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THE LEA BILL AND ITS OPERATION IN THE MUNICIPAL FIELD

ADDRESS

of

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The Lea Bill and Its Operation in the Municipal Field

The cycle of business failures and wide-spread defaults by business and governmental units which commenced even prior to 1929, focussed attention upon the twin problems of enforcement and readjustment. Where readjustment is necessary and feasible, there are the further problems of the development of a fair plan of readjustment, and of machinery for putting that plan into effect. Your group has devoted much study to these matters in the municipal field, and various aspects of the problem have been discussed before you at your last two annual meetings.

The general question of reorganization and readjustment has also been the subject of extensive Congressional investigations, including those by a Select Committee of the House and a Special Committee of the Senate. Various segments of the field have been given further study by standing Congressional committees in connection with specific pieces of pending legislation. In addition, the Securities and Exchange Commission was directed by Congress 1/ to undertake a study and investigation of the work, activities, personnel and functions of protective and reorganization committees.

The intensive study which has been devoted to these problems has already borne legislative fruit.

In the field of corporate reorganizations, section 77B of the Bankruptcy Act provided machinery for making a reorganization plan effective as against non-assenting minorities. The interests of dissenters were assumed to be adequately protected by two requirements: acceptance of the plan by a stated majority of the security holders affected, and a judicial determination of the fairness of the plan.

1/ By section 211 of the Securities Exchange Act of 1934. The first six parts of the Commission's report of its study and investigation have been completed and transmitted to Congress.

The original Sumners-Wilcox Act 2/ established comparable machinery for dealing with the problem of minority obstruction in the municipal field. The same general approach was followed in the new municipal compositions act, 3/ which was designed to avoid the constitutional flaws which a bare majority of the Supreme Court found to exist in the original act.

Both section 77B and the new municipal compositions act attach great weight to the acceptance of a particular plan by a stated majority of the security holders affected thereby. But neither statute establishes adequate controls over the vitally important process of negotiation of the terms of the plan and of obtaining its acceptance by the requisite percentage of the security holders. Under the municipal compositions act, the plan of composition must have been accepted by at least 51% in amount of the securities affected, before a petition can be filed. And under both statutes, the plan must have been accepted by the requisite percentage of the security holders before it comes before the court for a determination as to its fairness. The process of negotiation and formulation of the plan is carried on wholly outside the court proceedings. The problem of supervision and control of the solicitation of acceptances of the plan, a task normally performed by protective committees, is left practically untouched.

As a result, the protection afforded to the non-assenting security holder by the requirement of acceptance of the plan by a large majority of his fellow security holders is rendered illusory. Such acceptances have no real bearing upon the fairness of the plan unless they are the result of the exercise of a free and informed judgment, after full disclosure of all

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2/ Sections 78 to 80 of the Bankruptcy Act.
3/ Public No. 302, approved August 16, 1937.

material facts. And the failure to meet the protective committee problem largely impairs the value of the other protective device provided by the two statutes, namely, the requirement of court approval of the fairness and equity of the plan. It is undoubtedly true that if no objection is made some courts will almost automatically approve a plan which has been accepted by the requisite percentage of security holders. This is the result of the not unnatural tendency of such courts to overlook the fact that reorganization is as much an administrative as it is a judicial problem, and to carry over into reorganization proceedings a point of view which is perfectly proper in ordinary liquidation, namely, that the court's function is to act as an impartial arbiter between two or more contesting parties. Even where a non-assenting security holder appears and is given an opportunity to be heard the cogency of his arguments is likely to be obscured by the fact that a large majority of his fellow security holders have accepted the plan. Particularly is this true if the court fails to realize that such acceptances frequently evidence little more than the fact that the security holders have been in effect "locked in" by the customary iron-clad deposit agreement long before that particular plan was formulated. Finally, the court is under great practical compulsion to approve a plan for which the necessary acceptances have been obtained, unless it is obviously unfair or illegal. Much time, effort and money will frequently have been expended in negotiating the plan and in obtaining such acceptances. The court will naturally be extremely reluctant to cause additional delay and expense.

The corporate reorganization provisions of the Chandler Bill (H. R. 8046) represent substantial progress in the direction of giving real meaning to court approval of the reorganization plan and the acceptance thereof by the security holders. That bill was passed by the House during

the past session without a dissenting vote and is now pending before a subcommittee of the Senate Committee on the Judiciary. It makes mandatory the appointment of a disinterested trustee in the larger cases, in which there is a substantial investor interest. The disinterested trustee is charged with the duty of formulating a plan. He is made the focal point for negotiations leading up to the plan. Solicitation of acceptances is prohibited until after the court has approved the plan as being fair and equitable.

But the Chandler Bill does not provide a complete answer to other phases of the solicitation problem, and as I have already pointed out, the new municipal compositions act really does not purport to cover that aspect of the general question. Not only are the controls provided by that act of a very limited character, but protective committees will normally have sprung into existence long before those controls become operative through the institution of proceedings under the act. By that time their work will ordinarily have been substantially completed, for acceptance of the plan by 51% of the security holders is a prerequisite to the filing of a petition.

Some sort of supervision and control of solicitation practices therefore appears to be necessary and desirable, even in the case of reorganizations pending before a court, although that very fact may be assumed to afford a measure of protection. But regulation of solicitation practices is even more essential where court control of the reorganization process is not present, as in the case of voluntary reorganizations and readjustments in the corporate, municipal and foreign field.

The activities of protective committees and persons performing similar functions in reorganizations and readjustments are by and large still unregulated. Broadly speaking, the registration requirements of the Securities

Act of 1933 are applicable only to committees which seek the deposit of securities.4/ But the application of the registration requirements of the Securities Act is not at all pervasive even in the case of committees which seek the deposit of securities, by reason of the many exemptions of which protective committees may avail themselves under that Act. The exemption with which this group is undoubtedly most familiar is the one which was accorded, by the 1934 amendment of section 3(a)(2), to certificates of deposit for securities issued or guaranteed by States or political subdivisions or instrumentalities thereof. Other exemptions have almost as effectively removed from the scope of the Act solicitation activities in the field of judicial and voluntary reorganizations. 5/

The powers of the Securities and Exchange Commission under the Securities Exchange Act of 1934 over the solicitation of proxies, consents and authorizations are applicable only to securities registered on national securities exchanges. The Commission's jurisdiction over committees under Sections 11 and 12 of the Public Utility Holding Company Act of 1935 extends only to securities and reorganizations of registered holding companies and their subsidiaries.

4/ Committees which seek powers of attorney or proxies are generally not subject to the Securities Act, for ordinarily proxies are not so constituted as to come within the meaning of the term "security", as defined in that Act.

5/ For example, certificates of deposit are entitled to the exemption provided by section 3(a)(10), where the terms and conditions of their issuance and exchange for outstanding securities are approved by a court, official or agency of the United States or other governmental authority expressly authorized by law to give such approval. Committees seeking the deposit of securities in connection with proceedings under Section 77B not infrequently obtain such approval from the court. The courts have not been given a sufficiently specific standard for the granting or withholding of such approval, and have not afforded the measure of protection which recent investigations have shown to be necessary. Further, under section 3(a)(9) of the Securities Act, solicitation activities on the part of corporate managements seeking to effect so-called voluntary plans of reorganization may be exempted from the registration requirements.

As Congressman Wilcox pointed out in his testimony on the Lea Bill, it is little short of amazing that protective committees have escaped governmental supervision and regulation to the extent that they have, when we compare their powers and activities with those of national and state banks. Almost every detail of the organization and operation of a bank is subject to the strictest kind of governmental supervision, though its business may be purely local in character and though it may have only a few hundred thousand dollars of other people's money on deposit. Protective committees are custodians of other people's money in just as realistic a sense as are banks, yet neither their organization nor their activities are subject to any really effective governmental supervision or control. A self-constituted protective committee may, through a nation-wide solicitation campaign, secure the deposit of millions of dollars of bonds. In the municipal field, it may receive from the defaulting municipality interim or partial payments on those bonds amounting to hundreds of thousands of dollars. Protective committees unquestionably occupy a fiduciary position. But they themselves are in a position to fix the terms of their trusteeship. The only real check upon unfairness or inequity in the fixing of those terms is their own conscience. And that that is not an effective check is demonstrated, I think, by the Commission's study of several hundred representative forms of deposit agreement in actual use, including over one hundred from the municipal field.

All will agree that if the activities of protective committees are to be effectively regulated, federal legislation is necessary. The problem is truly national in scope. That fact has been conclusively demonstrated by the studies and investigations to which I have already referred. The last session of this Congress witnessed the introduction of at least three bills dealing with the general problem of protective committees. One of

these, (H.R. 6963), introduced by Congressman Sabath, had no application to committees operating in the municipal field. But the other two -- H. R. 116, introduced by Congressman Wilcox, and H. R. 6968 (the proposed "Committee Act of 1937"), introduced by Congressman Lea, are of general application.

Extensive public hearings were held on the Lea Bill before the House Committee on Interstate and Foreign Commerce. After the hearings were concluded, Chairman Lea released a revision of the bill, in the form of a committee print, embodying certain major changes. This revision was the result of various suggestions received during the course of the hearings. While the Committee has taken no official position, either with respect to the original bill or with respect to the revised print, I shall address myself to the provisions of the committee print, which is known as "Committee Print No. 2."

The Lea Bill is of general application to protective committees and other persons who solicit authorizations to represent security holders in connection with reorganizations, readjustments and debt arrangements. Like the Securities Act of 1933, it is grounded on the postal power and the commerce power, and is to be administered by the Securities and Exchange Commission. The bill applies to solicitations in connection with proceedings for reorganization under Section 77B, or in connection with receivership or foreclosure proceedings in Federal or State Courts. It also applies to a limited group of voluntary readjustments. Finally, it applies to municipal debt arrangements and foreign debt arrangements. The term "municipal debt arrangement" includes any modification or exchange of a security issued or guaranteed by a political subdivision or public instrumentality of a State or Territory. It also includes the assertion of any rights evidenced by any such security on which there is a default in principal or interest. Section 303(9).

The Lea Bill is directed at three phases of the protective committee problem. *First*, the necessity of full and fair disclosure of all material facts with regard to the organization of the Committee, its affiliations and its plans. *Second*, the elimination from deposit agreements and proxies of provisions which are unfair or unnecessary, or inconsistent with the fiduciary relationship to be assumed. *Third*, the disqualification from committee membership of persons who have interests materially conflicting with those of the security holders which they propose to represent. Apart from certain differences in the disqualification provisions, the controls established by the bill follow the same general pattern whether a judicial reorganization, voluntary readjustment or municipal or foreign debt arrangement is involved. So in discussing the operation of the Lea Bill in the municipal field, we will necessarily get a rather complete picture of the bill as a whole.

Section 305(a) is really the cornerstone of the bill. With a single exception, 6/ all of the substantive provisions of the bill are made effective through the registration and disclosure requirements of that section. It prohibits any person from soliciting by use of the mails or means or instrumentalities of interstate commerce, any proxy, deposit or assent, unless a declaration is effective as to such action by such person, and unless a proper prospectus accompanies or precedes such solicitation.

Before we consider in detail the substantive provisions of the bill relating to solicitations in connection with municipal debt arrangements, we should have clearly in mind the precise scope of the bill.

6/ Section 313, which prohibits solicitations by fraudulent or misleading methods, and the "puffing" of a plan by an ostensibly disinterested person without disclosing the fact that a consideration is being received by him. This section is analogous to section 17 of the Securities Act of 1933.

Certain classes of solicitations are specifically exempted. Of these exemptions, the most important from the point of view of this group are those provided for solicitations in respect of securities issued or guaranteed by States, and for solicitations in respect of securities issued or guaranteed by a political subdivision or public instrumentality of a State or Territory, where the solicitation is made by the issuer or guarantor, or in its name and on its behalf by its employees. 7/ Other exemptions make the registration and disclosure requirements inapplicable to solicitations commenced prior to the effective date of the bill, and solicitations which are limited in scope or character. 8/

We have already noted that the bill applies only to the solicitation of proxies, deposits and assents. Another limitation upon the scope of the bill in the municipal field arises from the definitions of those three terms. 9/ The term "assent" is defined as an assent to a plan of voluntary readjustment. Assents to reorganization plans and plans of municipal or foreign debt arrangement are not included. In the municipal field, therefore, we are concerned only with solicitations of "proxies" or "deposits".

As respects municipal securities, a "proxy" is an authorization to act for or to represent a security holder in connection with or in an endeavor to

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7/ See sections 304(a)(8) and 304(a)(9).

8/ By virtue of sections 304(a)(1) and 304(a)(2), solicitations commenced prior to the sixtieth day after the enactment of the bill may be continued after that date without compliance with the requirements of section 305(a). Section 304(b) empowers the Commission to exempt additional classes of solicitations, where the amount of outstanding securities of the class to be solicited is less than $100,000, or where the solicitation is of a limited character.

9/ See sections 303(13), (14) and (15).

effect a municipal debt arrangement, but such an authorization constitutes a "proxy" only if it involves the exercise of discretion by the person who receives it. A "deposit" is a surrender of custody or possession of a security which constitutes a "proxy", as defined above. An authorization and direction to perform a specific act on behalf of a security holder, whether or not accompanied by the actual physical surrender of his securities, is therefore neither a "proxy" nor a "deposit" as such terms are defined in the bill.

To sum up: So far as municipal securities are concerned, the bill covers only solicitations of authority to act in a representative capacity -- a fiduciary capacity -- for security holders. The registration requirements would therefore clearly apply to solicitations by municipal protective committees. A debt arrangement proposed by a municipality, directly or through its agents, without the intervention of a protective committee, would ordinarily not be subject to the provisions of the Lea Bill. Such proposals do not commonly involve the solicitation of a discretionary authorization. But what is more important, solicitations by the municipality itself, or in its name and on its behalf by its employees, are specifically exempted from the registration requirements.

Disclosure Requirements

As we have seen, section 305(a) establishes two conditions precedent to the solicitation of proxies or deposits by use of the mails or means or instrumentalities of interstate commerce. First, a "declaration" containing certain information must have been filed with the Commission by the person or persons by whom the authority is to be exercised, and must have become

effective. 10/ Second, a prospectus that meets certain minimum requirements must accompany or precede the solicitation. 11/ These requirements are comparable to the registration and prospectus requirements of the Securities Act. And, apart from the question of possible interference with state sovereignty which arises only in the municipal field, the imposition upon protective committees of registration and disclosure requirements raises no more serious constitutional questions than the Securities Act itself.

There can be no dissent from the proposition that persons who propose to solicit authorizations to represent security holders should make full and fair disclosure of all the material facts. Reasonable men may differ as to the extent to which it is necessary and practicable to go in order to satisfy the requirement of full and fair disclosure. But the disclosure requirements of the Lea Bill are certainly no more onerous than those of the Securities Act. The bill expressly permits 12/ the omission from the declaration of information or documents which are not obtainable without unreasonable effort

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10/ Section 306 contains the provisions with regard to the contents of the declaration, the filing thereof and of amendments thereto, and the becoming effective of the declaration and of such amendments.

The declarants may designate in their declaration, or in any amendment, persons who are to be authorized to solicit on their behalf. The declaration becomes effective only as to the declarants and such authorized solicitors. Where the personnel of a committee changes after the effective date of the declaration, as by the death or resignation of a member, and the designation of a successor, or where the plan to which an effective declaration relates is amended, the matter may be taken care of by post-effective amendment.

A declaration becomes effective 15 days after the filing thereof, unless it appears to the Commission that grounds for the issuance of a refusal order exist, and the Commission issues an order to show cause why the declaration should become effective. If a show-cause order is issued, an opportunity for hearing must be given within 10 days, and within a reasonable time thereafter the Commission must enter either an order fixing the date on which the declaration will become effective, or an order under section 307 or section 308 refusing to permit the declaration to become effective as to one or more or all of the persons or matters designated therein.

11/ The requirements with respect to the contents of the prospectus are set forth in section 309.

12/ Last paragraph of section 306(a).

or expense, or information which rests peculiarly within the knowledge of an independent third party. Besides, the absence from the Lea Bill of a provision, similar to that contained in the Securities Act, imposing civil liability in respect of statements or omissions in documents filed or in prospectuses used represents a further recognition of the practical difficulties with which a protective committee may be confronted in obtaining certain of the information required.

As we all know, until its amendment in 1934, the registration and disclosure requirements of the Securities Act applied to municipal committees, as well as to other committees. The considerations which led to the exemption of municipal committees in 1934 were not so much any assumed constitutional difficulties, not so much any supposed lack of necessity for registration, but rather a reluctance to holding committee members too strictly accountable for the accuracy of information for which they frequently had to rely upon the municipality itself. Those objections are met in the Lea Bill, the declaration and prospectus provisions of which establish disclosure requirements which, I believe, can and should be complied with by all protective committees.

Control over the Terms of Proxies and Deposit Agreements

The Lea Bill also sets up certain legislative standards as to the terms and conditions upon which proxies and deposits may be solicited. 13/ Compliance with these standards is to be enforced through the issuance of an order refusing to permit the declaration to become effective. 14/

We are all familiar with the way in which protective committees are customarily organized, and with their methods of operation. But a brief resume of present practices is necessary if we are to place these provisions of the Lea Bill in their proper setting.

13/ See sections 307(a)(6) and 311.
14/ Sections 307(a)(5) and 308(7).

Occasionally a committee will solicit proxies, but it will generally elect to seek deposits instead, for reasons which clearly appear from a consideration of the terms of the conventional deposit agreement.

We all know that deposit agreements commonly vest broad powers in the committee. The committee is almost invariably given title to the deposited securities, or authorized to take title whenever it desires, together with all the rights and powers which such ownership implies. But the deposit agreement does not expressly impose upon the committee any duty to exercise these rights and powers, and if it does see fit to exercise them, it has the benefit of broad exculpatory clauses exempting it from liability except for gross negligence and, in some cases, only for actual fraud.

We all know that the security holders, once they have deposited their securities, have practically no power to direct the committee's activities; no power to terminate the authority conferred, or even to express their *dissent* from any action taken or proposed, except by the withdrawal of their securities. But many deposit agreements give no right of withdrawal at all prior to the expiration of the agreement, and where a right of withdrawal exists, as upon the promulgation or amendment of a plan, it is almost invariably conditioned upon payment of the depositor's pro rata share of the fees and expenses of the committee.

These provisions bring into sharp relief the question of how these fees and expenses are determined. Committees are customarily given a lien upon the deposited securities for their expenses. Provision is generally made for the payment of compensation to the committee members, and they are given a lien therefor. But no provision is made for the independent review of the expenses and compensation of the committee. Comparatively few agreements provide any limit thereon, and where a limit is provided it is ordinarily based upon a fixed - and liberal - percentage of the face amount of the

deposited bonds, which is necessarily an arbitrary figure. For all practical purposes, then, the committee itself is made the sole arbiter of the propriety and amount of its fees and expenses, and therefore of the amount of the withdrawal charge.

Again, under most deposit agreements, the committee is under no obligation to render any account until the agreement expires; under many agreements the committee is not required to account at all. Few agreements require a copy of the accounting to be sent to the depositors. In most cases the account is merely filed with the depositary, and a depositor who desires to question the account is faced with short time limits, and restrictions as to the manner in which the objection may be made.

Finally, most deposit agreements expressly permit members of the committee to trade in securities of the municipality or certificates of deposit for such securities, and to acquire a pecuniary interest in matters relating to the deposit agreement or the plan.

There seems to be a tendency, on the part of those whose primary interests lie in the municipal field, to maintain that municipal protective committees should be excluded from the operation of any measures providing for the regulation of protective committees. But the Commission's study of the general subject clearly shows that the foregoing summary of the provisions of the conventional deposit agreement is equally applicable to the typical deposit agreement in use in the municipal field. 15/ To the extent that such provisions are found to be unfair and inequitable, therefore, municipal protective committees cannot escape their fair share of the responsibility.

15/ The results of the Commission's examination of 126 deposit agreements for securities of municipalities and special districts are set forth in Part IV of the report of its Protective Committee Study.

We would all agree, I am sure, that at least some of the provisions to which I have referred are inconsistent with the fiduciary nature of the relationship between the protective committee and its depositors, particularly the provisions which confer upon the committee members the uncontrolled power to fix their own compensation, and the provisions relating to trading by committee members and accountings by them. With respect to all these matters, the interests of the committee members come into direct conflict with those of their depositors. No one denies that members of a protective committee are, in the eyes of the law, trustees.16/ It is too clear for argument that, apart from some express provision in the trust instrument, a trustee should not have interest materially conflicting with the interests of the persons represented by it. The common law jealously guards against conflicting interests between the trustee and his cestuis. His transactions with himself as trustee are subject to the closest scrutiny, and he must account for any profits which may accrue to him individually in the administration of the trust. He may not defeat these requirements by establishing that the particular transaction was fair. The common law takes no chances--it holds that cestuis are entitled to the independent judgment of a trustee who has no conflicting interests.

There would also be general agreement, I believe, that in many respects the typical deposit agreement confers unnecessarily broad powers upon the committee, and unduly restricts the right of the security holders to control the committee's activities, and even to express their views.

It is no answer to say that the security holders, in depositing their securities, have expressly assented to all the terms of the deposit agreement,

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16/ They must be prepared to establish that they are in reality trustees, unless they wish to endanger their right of access to the Federal Courts on the ground of diversity of citizenship. *Bullard* v. *Cisco*, 290 U.S. 179 (1933).

and that the certificate of deposit specifically so provides. It is no answer to say that the deposit agreement expressly permits the committee members to have conflicting interests, or otherwise to conduct themselves in a manner inconsistent with the common law standards of trusteeship. The individual investor is not in the position of a person who, in creating a trust of his property, voluntarily selects a trustee whom he knows to have a materially conflicting interest. He is not in the position of a person who, in creating a trust, voluntarily confers upon the trustee immunity from one or more of the disabilities or responsibilities imposed upon trustees by the common law. We all know that the members of protective committees are not selected by the security holders; that they are selected by themselves. We all know that they frequently neither own nor represent any securities of the class to be solicited; that not infrequently they are composed of what may be called professional committee men; that it may be said with considerable justice that the only qualification which is essential under the present practice is access to lists of the names and addresses of the bondholders. It is literally true that a protective committee is in the position of soliciting appointment as trustee, and on terms dictated by itself. The individual security holder never sees the deposit agreement; he has no conception of the fiduciary nature of the relationship and its common law incidents, or of the extent to which they have been whittled away by the provisions of the deposit agreement; and even if the fullest explanation and disclosure were made, his only choice would be between depositing and doing nothing at all. The individual holder of a defaulted bond is in a much more helpless position than the purchaser of an insurance policy, for whose protection standard forms of policies have long been prescribed by statute.

If future deposit agreements are to be drafted along more equitable lines; if they are to give fuller recognition to the high fiduciary character of the relationship between committee and depositor; if these objectives are to be achieved, it is clear that we must rely upon some one other than the security holders and the committee members themselves. The only answer, it seems to me, lies in uniform regulation of the drafting process by some governmental agency. This is what the Lea Bill proposes to do.

In the first place, the bill imposes restrictions upon the purposes for which deposits may be solicited. 17/ Deposits are permitted for the purpose of tendering the deposited securities in order to effect an acceptance of the plan, or an exchange of securities pursuant to the plan, or for the purpose of instituting suits or collecting payments or distributions on account of the deposited securities. Deposits may be solicited for other purposes where the Commission deems it necessary for the protection of investors.

Secondly, the bill in effect bars the solicitation of proxies or deposits which constitute a general authorization to assent to a plan which has not yet been formulated, thus insuring that the security holders will have an opportunity to see what their authorizations actually cover. 18/ The other requirements are also applicable to proxies and deposits alike.

Adequate provision must be made for the independent review and determination of the committee's fees and expenses, and for at least an annual report and accounting. 19/

17/ Section 311(a)(6). Clause (A) of that section would ordinarily have no application in the case of municipal securities.
18/ Section 307(a)(6).
19/ Sections 311(a)(1) and (2).

Adequate provision must also be made for penalties upon trading by committee members, their attorneys, solicitors and affiliates, so long as the fiduciary relationship continues. Similar penalties must be imposed upon the acquisition by committee members or their affiliates of any pecuniary interest in any contracts, arrangements or undertakings with the issuer during that period. 20/

Finally, satisfactory limitations must be imposed upon the employment of attorneys which have or represent materially conflicting interests. 21/

Qualifications of Committee Members.

The Lea Bill also establishes certain legislative standards as to the qualifications of committee members. 22/ Like the provisions with respect to the terms upon which solicitations may be made, compliance with these standards is also to be enforced through the issuance of a refusal order.

No one would seriously argue that a person who has an interest which obviously materially conflicts with the interests of a particular class of bondholders, is a proper representative of those bondholders. Nor is a person whose sole interest in the situation is the compensation or opportunities for profit which may accrue to him as a result of membership on a protective committee. But even if there is the fullest disclosure of the existence of the disqualifying circumstance, and the most complete exposition of the dangers inherent in its existence, the individual investor has no place else to turn, if the person in question has control of the means of communication with the bondholders, through access to the

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20/ Sections 311(a)(3) and (4).
21/ Section 311(b)(1).
22/ Section 307(a)(1) to (4), inclusive; section 308(3) to (6), inclusive.

bondholders lists. In a very real sense, the same considerations that require supervision of the terms of proxies and deposit agreements also necessitate governmental control over the qualifications of committee members. The provisions of the Lea Bill supply this need.

Committee membership is to be limited to persons who have a bona fide interest in the situation, that is, persons who own or at least represent securities of at least one of the classes to be solicited. 23/ And the representation of two or more classes of security holders whose interests are themselves in material conflict is barred by the bill, unless the public interest or the protection of investors otherwise requires. 24/

It would be impracticable to anticipate every situation in which all would agree that the owner of a particular security, claim or interest should not be permitted to act as trustee for a particular class of security. The bill therefore makes provision for the administrative determination and control of such materially conflicting interests. 25/

Finally, principal underwriters of outstanding securities of an issuer, and officials of such underwriters, are barred from serving on protective committees for securities of that issuer. 26/ I do not regard this provision as a legislative denial of the existence of the "moral obligation" which is owed by underwriters to those who have purchased securities from them. By reason of their familiarity with the financial affairs and problems of municipalities whose securities they have marketed, their knowledge of the names and addresses of their customers, and their

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23/ Section 307(a)(1).
24/ Section 307(a)(2).
25/ Section 308(3); and compare sections 308(4) to (6), inclusive.
26/ Section 307(a)(4). Under section 303(17), the Commission is authorized to declare any class of persons not to be underwriters for the purposes of this provision if in its opinion such persons are not principal underwriters.

ability to enlist the cooperation of dealers throughout the country, they are in a position to render invaluable service to protective committees when those securities go into default, and they should render that service. But it is not necessary, in order to render that service, that underwriters be represented on such protective committees, and experience has demonstrated that it is inadvisable to entrust control of the readjustment machinery to those whose individual interests are so frequently in conflict with those of the security holders themselves. Underwriters should not exact such control as the price of the discharge of their moral obligation.

Applicability to Fiscal Agents

Some concern was expressed, at the hearings on the original bill, about its supposed applicability to voluntary refunding plans, that is, plans proposed by a municipality through a bond house as fiscal agent, without the intervention of a protective committee. Whatever grounds there may originally have been for this belief, such plans would ordinarily not be subject to the revised bill.

It may be said, of course, that the exemption of solicitations by "employees" of a municipality will in many cases be unavailable with respect to such fiscal agents, whose relation to the municipality is normally that of "independent contractor", rather than that of employee. 27/ But by virtue of the definitions of the terms "proxy" and "deposit", the registration requirements would nevertheless be inapplicable to solicitations by such fiscal agents, unless the subject matter of the solicitation was an authorization to act in a representative capacity -- a fiduciary capacity -- for the security holders.

27/ In *Metcalf & Eddy* v. *Mitchell*, 269 U.S. 514 (1926), a statutory exemption, for purposes of federal income taxation, of "officers and employees" of "any State...or any local subdivision thereof" was held unavailable to a partnership of consulting engineers who were found to be in the position of independent contractors, rather than employees.

In other words, if the fiscal agent solicits merely an outright assent to the plan, a mere ballot, he will be outside the scope of the bill. Similarly, if he solicits an outright exchange of old securities for new, or actually buys in the old securities for the account of the municipality, he will not be subject to the registration requirements. But if he proposes to act in a dual capacity, if he proposes to become the representative of the security holders as well as the representative of the municipality, there is all the more reason for subjecting him to the requirements of the bill.

The application of the Lea Bill in this situation raises no Constitutional difficulties. It is clear that independent contractors are not such instrumentalities of the municipality which they serve as to be necessarily exempt from federal regulation, under the doctrine of State sovereignty. It is a question in each case as to whether a particular exercise of a particular Congressional power impairs in a substantial manner the independent contractor's ability to discharge its obligations to the municipality, or the ability of the municipality to procure the services of private individuals to aid them in their undertakings. 28/ Certainly fiscal agents can discharge their obligations to the municipality without at the same time assuming to move into a fiduciary position with respect to the security holders. It is only when they do so that they become subject to the registration requirements. And it seems clear that the ability of a municipality to procure the services of fiscal agents to assist it in refunding operations is in no way impaired. So far as the application of the bill to individuals and protective committees purporting to act for creditors is concerned, of course, the case for constitutionality is an *a fortiori* one.

28/ *Metcalf & Eddy* v. *Mitchell*, supra note 27. It is true that this case, like many of the cases which have provided the occasion for the application of the doctrine, was a tax case. But the mail power and the commerce power, as well as the bankruptcy power, are granted by the same Article and Section of the Constitution as the taxing power so it is probable that the same principles will be invoked where an attempted exercise of the mail or commerce power is involved. Indeed, in *Ashton* v. *Cameron County Water Improvement District No. 1*, 298 U.S. 513 (1936)

The fiscal agent, then, need not comply with the provisions of the Lea Bill unless he is soliciting "proxies" or "deposits". As a matter of fact, there is a growing feeling that the activities of fiscal agents in connection with municipal refunding programs should be subject to the disclosure requirements of the Securities Act, even where they are soliciting outright assents or exchanges. They, as well as the municipalities themselves, are of course exempt at the present time. The fiscal agent is usually one of originating houses. He is selected for that very reason--he knows who his original customers were and can enlist the aid of municipal bond dealers throughout the country in tracing subsequent purchasers. His compensation from the municipality is frequently based upon his success in procuring assents to the plan which the municipality is proposing. These circumstances do not make for careful study of the merits of the plan by the fiscal agent, or for full and fair disclosure to the bondholders of the material facts, including the fact of his employment by the municipality. We have spoken of the underwriter's moral obligation to those who have purchased securities from him; of the tendency of those purchasers to look to the underwriter in times of distress. That very tendency makes full disclosure more essential in these situations, for if such disclosure is not made the bondholder is not unlikely to assume that the underwriter is working for his interests rather than those of the municipality.

A strong case could certainly be made for some type of control over the activities of fiscal agents in connection with municipal refundings. But the Lea Bill does not purport to cover that phase of the general problem. Fiscal agents do not come within the scope of the bill unless they actually assume to act in a representative capacity, to perform the functions ordinarily performed by a protective committee.

28 continued/ a majority of the Supreme Court found a warrant, in this very juxtaposition, for treating the restrictions worked out in the tax cases as being equally applicable to the bankruptcy power.

Conclusion

It has been urged that the emergency which gave rise to the necessity for governmental supervision and control of municipal protective committees has largely passed; that the major refunding operations have already been completed; and that long strides have been made in the direction of clearing up the financial difficulties of the smaller units. We have already seen that the Lea Bill has no application to solicitations commenced prior to its enactment. But, if the objectives of the bill are sound, as I think they are, there is no reason why investors should be denied its benefits, in those cases in which refunding operations have not yet been commenced. Further, there is always a considerable lag between the enactment of remedial legislation and the occurrence of the events which gave rise to its enactment. If we wait for another cycle of municipal defaults, we shall again be too late.

The Lea Bill will protect investors from the importunities of protective committees which have no real interest in the situation except the opportunities it presents for personal profit, or which have interests which actually conflict with those of the investor itself; it will prevent committees from conditioning their offer of representation upon the acceptance of unfair and inequitable terms; and it will assure to the investors full and fair disclosure of all the material facts.