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ADDRESS

of

ROBERT E. HEALY

Member, Securities and Exchange Commission

at the

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of the

NATIONAL ASSOCIATION OF RAILROAD AND UTILITIES COMMISSIONERS

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The events which led up to the passage of the Public Utility Holding Company Act of 1935 are an old story to all of you. I shall not recite those events or discuss very much the subject of holding company abuses. Instead, because of a request that came to me from the President of our Association, I shall speak of some of our experiences in administering the Act since companies subject thereto were required to register with the Securities and Exchange Commission. There are many phases of this experience which relate to problems which I know are facing you in your several State Commissions.

I shall talk of some specific cases which have come before us in the past eighteen months, because I feel that is the best way of illustrating some of the many points of contact that exist between you in the several States and us in Washington. In doing this, I shall run over some of the more fundamental steps we have taken in connection with requirements for registered holding companies.

We all know that State regulatory bodies have too often found themselves seriously handicapped, even balked, in their attempt to supervise local operating companies because they had no power over the parent holding companies and little reliable information about them, and so found it difficult to regulate or even analyze important intercompany relationships. The Holding Company Act was not intended to supplant State regulation but to supplement it be giving a Federal agency – the Securities and Exchange Commission – jurisdiction over the uncontrolled holding companies.

We have adopted two major measures – first, a form of registration statement, and, second, a Uniform System of Accounts for Public Utility Holding Companies.

The registration form calls for a complete description of the business and properties of the registrants and for detailed information on the structure of registered holding company systems, including charts and tables showing interlocking relationships in full. This information provides a complete picture of the financial set-up of the registering holding company and all of its subsidiaries, presenting detailed data on its outstanding securities, investments, bank loans, intercompany loans, etc. This picture is available for you to examine in all its details.

The holding company must submit a list of the twenty largest stockholders of each class of its stock and the beneficial owners of such securities if known. It must also furnish the number of security holders in each of several size groups.

Another question calls for a description of the financial interest of indenture trustees which would or might cause a substantial conflict of interest between the trustees and the holders of the registrant's securities. The registrant must also reveal any agreements it may have with underwriters as to future issues of securities. This is information which can be vital to you in your work.

The form calls for "consolidating" as contrasted with "consolidated" statements of income, surplus and balance sheets, thus showing the separate figures of the subsidiary companies from which the final composite figures are adduced. We believe that this form of financial reporting should be much more valuable than the customary "consolidated" form.

Where write-ups still exist, the form asks for "a brief description of each major revaluation of investments or of fixed assets (whether tangible or intangible) which was made since January 1, 1915, and reflected in the fixed asset accounts or in the investment accounts on the books of the registrant or any subsidiary company thereof or on the books of any predecessor of any such company." The form asks whether such revaluation was approved by a State Commission or public body, the amount of the resultant increase or decrease, and how the company's accounts were affected.

Incidentally, I should like to call your attention to the extensive and valuable information with reference to the operations and financial status of public utility companies which may be obtained from the registration statements and annual reports filed by companies in compliance with the Securities Act of 1933 and the Securities Exchange Act of 1934. Up to June 30, 1937, there had been registered under the Securities Act $4,000,000,000 of public utility securities, setting forth the financial and operating records of the companies. Further, every public utility company having shares listed on exchanges has had to file a similar report about its affairs and must continue to file comprehensive annual reports. These statements are on file in the

Washington office and some of the regional offices of the Commission and they are readily available to interested parties. There are numerous instances where write-ups and various other unorthodox practices of accounting legerdemain can be discovered by those whose eyes are trained in such matters. It seems to me that this information should be helpful to State Regulatory Commissions in the performance of their duties.

The Uniform System of Accounts for Public Utility Holding Companies to which I referred earlier is a system designed to apply to those registered holding companies “deriving practically all their income from dividends and interest on investments in other companies.” In drafting this system, we have attempted to accomplish two things. First we have sought to render methods of accounting deception impossible. Second, we have attempted to standardize so that an investor who can read one holding company balance sheet will be better able to read and understand them all, and make intelligent comparisons between systems.

The classification includes provisions designed to eliminate the practice of writing up the value of investments in balance sheets, a requirement for the segregation of capital surplus and earned surplus, and strict limitations as to the extent and manner in which stock dividends from subsidiaries may be taken into income or surplus. Not strict enough, however, if I may interject a wholly personal view. The requirement for the entry of investments is that they must be taken into the accounts at cost and held at cost until sold or written down. Special provisions allowing a reasonable amount of elasticity in the application of this requirement are made for reorganizations, bankruptcies and the like. Dividends may not be credited to the dividend account before they have been paid or declared. A company may not take up on its books the undistributed earnings of other companies. To provide for the study of several matters, the rules call for a transcript of each reporting company’s surplus accounts from its inception to January 1, 1937. This data will facilitate determination of the problem of separation of earned and capital surpluses. The classification became effective January 1, 1937. All registered holding companies are now required to keep their accounts in accordance therewith so that the balance sheets and accompanying income statements which will be published as of December 31, 1937, by registered holding companies will all be for the first time on a uniform and comparative basis.

The service company, you well know, was a favorite device by holding companies to extract from their operating subsidiaries excessive or unearned management and service fees. The excessive or unearned service fee was a special dividend disguised as an operating expense and was a betrayal of the true principles of rate regulation. All of you have undoubtedly encountered this vexatious problem and wrestled with it. Some of you must have had great difficulty with it because of the inadequacy of state statutes or appropriations or because of lack of access to holding company records and for other reasons. The Act prohibits such charges by holding companies. They are also prohibited by holding company affiliates except at cost and except by subsidiary or mutual service companies organized to render such services. The Commission has promulgated rules under which such service companies must apply for approval by the Commission.

Each registered holding company system in which services are performed for subsidiary companies has organized one or more service companies and made application for their approval. In order to measure the operating results of these service companies and to determine if they are functioning as required by the Act, the Commission promulgated on August 1, 1936, a Uniform System of Accounts for Service Companies. The first reports under this uniform system of accounts are now being analyzed by the staff of the Commission. It is possible that in addition the Commission's accountants will make certain field studies of methods used by different companies in allocating costs for service.

Copies of the annual reports of these service companies are available to any State Commission. They show in detail precisely what any company, in which a State Commission is interested, received in the way of service and what it paid therefor. We believe this may be of substantial value to you in this solution of rate problems. The Securities and Exchange Commission will welcome any suggestions which any State Commission may care to make after studying these reports. You will note that in these accounting matters the action we have taken has simply been along lines which will provide State Commissions with additional information which they may find helpful in the regulation of the operating companies under their jurisdiction.

In the determination of the all-important question of proper rates it is, of course, essential that each State Commission shall have the accounts of the companies under their jurisdiction presented to them in such a way as will give them the information that they feel is necessary. The Securities and Exchange Commission has consequently made no attempt to promulgate accounting procedures for operating companies but it has watched with much gratification the progress which is being made by State Commissions in adopting their uniform system of accounts. The system seems to be a good one. Incidently it will facilitate comparisons between operating companies in different parts of the United States. Personally I regard the making and preservation of the record of the historical cost of properties in available form as of the utmost importance.

The acquisition by an operating public utility company of utility assets where the transaction has been authorized by a State Commission is, by the language of the Act, expressly exempted from the provisions of the Act. Acquisition by an operating company of securities of another operating company is also exempted under certain conditions. However, the exemption provisions with reference to securities are not as broad as those applied to utility assets because, I think, Congress wished to reserve to the Federal Government some control over the development of public utility holding company systems and to prevent further building up of top-heavy – sprawling – pyramided interstate systems.

It is remarkable that heretofore Government has had so little power as to the direction which growth and ownership should take on a national scale in an industry which is said to be dedicated to a public use and to be affected with a public interest, which has had delegated to it by the State the sovereign power of eminent domain, which enjoys very valuable protection against competition, which so often occupies streets and highways and dams the great interstate and international streams without charge and which owes its corporate existence to the State.

In cases which come before us with reference to the acquisition of securities, this Commission has endeavored to cooperate with local commissions. For example in the case of the Commonwealth Edison Company, which proposes to offer an exchange of its common stock for the common and preferred stock of the Public Service Company of Northern Illinois and the preferred stock of Illinois Northern Utilities Company and Western United Gas and Electric Company, we have cooperated to the fullest extent with the Illinois Commerce Commission, which has primary jurisdiction over the affairs of the companies involved. On several occasions representatives of this Commission went to Chicago to confer with the staff of the Illinois Commerce Commission, and it in turn sent representatives to Washington to confer with us. The Illinois Commerce Commission has already issued its order approving this transaction, and the Securities and Exchange Commission Order disposing of the case will be issued ere long.

In the matter of reorganizations, the Securities and Exchange Commission has been charged with great responsibilities. Too often in the past both the courts and local commissions have been confronted by plans devised by committees ostensibly working for security holders, whereas, in all too many cases the plans proposed have been for the benefit of the individual committee members and to the detriment of the security holders whom they were supposed to represent.

In an attempt to prevent the abuses of the past, the Commission has worked out rules under the Act covering the solicitation of proxies and the deposit of securities. Briefly, these rules provide that before there may be a solicitation of any consent to or dissent from any plan of reorganization, including deposits of securities for such purposes, a report on the plan must be obtained from the Commission. An application for such a report may be made by any person having a bona fide interest in the reorganization. The rules require that the application contain comprehensive information as to the terms of the plan and as to the fairness and feasibility of the plan, the interests of the reorganizers and the persons making the solicitation, information as to the expenses and compensation to be paid in connection with the proposed reorganization, opinions of counsel, and certain other relevant information. Any person desiring to solicit any such consent or dissent must also file with the Commission a declaration setting forth the manner in which the solicitation is to be made and much of the information required to be obtained in an application for a report on a plan, together with copies of the letters and other material to be sent to security holders. The rules also call for periodical accounting by committees, and prohibit committee members from trading in securities affected by the reorganization.

The Commission is given further responsibilities with reference to the reorganization of companies which either voluntarily or involuntarily have been placed under the protection of the Federal courts. A plan of reorganization in such a situation "shall not become effective unless such plan shall have been approved by the Commission." The Court may appoint the Commission trustee if it consents thereto, and in any event the Court may not appoint a trustee without first notifying the Commission and giving it an opportunity to be heard.

As a case in point, you recall that the Utilities Power & Light Corporation voluntarily went into 77B last January. Judge Holly of the United States District Court for Northern Illinois has jurisdiction of the case. The Commission felt that in order to properly discharge the obligations placed upon it, there should be an independent trustee in charge who could study in a dispassionate and an objective way the rights of the various classes of security holders, the needs of the consuming public, and the many other complex problems which are always present in a situation of this kind. For that reason the Commission appeared in court as amicus curiae and vigorously argued for the appointment of a trustee. The Judge made such an appointment, in the face of strong objections, and unless he should be reversed by the Circuit Court of Appeals, the trustee will administer the affairs of the Utilities Power & Light Corporation until such time as a sound plan for reorganization can be developed and approved by the parties at interest. The legal situation is complicated by the claim that the corporation is not insolvent and by the motion of the corporation to withdraw is 77B application.

During the time the Act has been in effect, the Commission has had before it applications or declarations under nearly all the provisions of the Act. Both in number and in importance those having to do with the issuance of securities have exceeded all the rest. In the aggregate, we have had before us security issues totaling over $1,000,000,000. In view of prevailing conditions in the money market, these applications have given rise to a most interesting problem. As you know, during the last eighteen months or two years, public utility companies have been busily engaged in retiring outstanding security issues and replacing them with others bearing a lower rate of interest. This volume of refinancing has revived the perennial question regarding the position of a public utility company's debt in its capital structure. As some companies, fortunately few among the operating companies, experienced difficulty in meeting debt maturities which occurred during the early days of the depression, we have again heard the talk of the necessity of a public utility company paying off its obligations and reducing its debt. The customary suggestion is that provision be required for several maturities or sinking funds which would retire a substantial portion of the company's obligations before their maturity.

Color was lent to proposals of this type by the fact that while the industry had been a constantly expanding one, requiring ever-increasing amounts of additional capital, there was a period three or four years ago when it appeared that the limit might have been reached and that the provision of new capital might not again be the serious problem it had been theretofore. Certainly if a business is not in constant need of additional capital, sound management will set about retiring its debt, and unsound management ought to be forced to do so; but where a business is in need of additional capital, a grave question arises as to whether it is economically sound to pay off one set of creditors if the company must immediately reborrow that sum, and more in addition, from another set of creditors. As you all know, the utility business requires an investment of from $4.00 to $6.00 for every increased dollar of gross revenues. At present, there is every indication that the expansion of the industry has not come to an end that the utility business will soon require substantially increased facilities in order to take care of the growing demands made upon it. The need for additional capital will inevitably follow. It is agreed that the capital actually invested in the preferred and common stocks of operating companies is entitled to a reasonable return. Therefore, when an operating company has invested the additions to its depreciation or retirement reserve and the addition to earned surplus, which conservatism requires should be made from year to year, it has no other recourse but to enter the capital market for any further funds required.

It has seemed to some of us that a sounder approach to the debt problem is to regard debt from a relative rather than from an absolute point of view. Therefore, the interests of the public, consumers and investors would seem to be better protected by an insistence upon increased maintenance and depreciation provisions in indentures and by further restricting the percentage of debt that can be issued against additions. By so doing, there are retained in the business earnings that might otherwise be paid out as dividends, and a larger percentage of the company's capital has to be raised through the medium of junior securities. Under such a policy, the total debt might show an increase from year to year, but its ratio to the company's sound assets would not increase and in fact might show a tendency to decrease.

To prevent an accumulation of idle cash in depreciation or retirement reserve funds during periods of low capital requirements, it seems well to have the indenture provide that such cash as is not invested in property be used for the purchase and cancellation of outstanding obligations. In spite of all of this, however, in the absence of a program of expansion, my personal conviction is that it is unwise to fail to plan on the eventual retirement of debt, and that a program of perpetual refunding is bad.

I have a few figures in which you may be interested, showing the results of the resent widespread financing which has taken place among operating companies. We picked some thirty-five large companies which had continuous corporate histories between December 31, 1925 and December 31, 1936. As a result of recent refinancing of their senior securities, the average interest rate on funded debt declined from 5.05% on December 31, 1925, to 4.44% on December 31, 1936. We have also analyzed the registration statements filed with us covering public offerings by operating electric, gas, water, telephone, and traction companies (although some of these are not within our jurisdiction under the Holding Company Act) for the period January 1, 1935, through June 30, 1937, together with data in our files covering certain issues that were privately placed in the same period. Without taking into consideration the charges for amortization of call premiums, discounts, etc., this analysis shows that an annual saving of more than $40,000,000 in out-of-pocket interest payments has been effected during these two and a half years. While refinancing has to a large extent been confined to bonds and debentures, certain of the companies have also been able to reduce the dividend rate on their preferred stock issues. In the aggregate, such reductions during the same two and a half years have amounted to approximately an additional $1,400,000 annually.

In the more or less typical capital structure whereby 50% of the capital is obtained through the issuance of bonds and about 25% through the issuance of preferred stock, it is obvious that every dollar saved in cost of money obtained from these two sources will be added to the amount available for dividends on the common stock.

The Supreme Court in the case of Bluefield Water Works and Improvement Company vs. Public Service Commission, 262 U.S. 679, stated

> "A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally."

From this language and from a realization of prevailing low interest rates, two points occur to me. First, what is now a fair rate of return? Obviously it is not what it was when money loaned on first mortgage bonds was receiving five or six percent interest. In fixing rates, the rate of return may be as important as the rate base. Second, who is going to get the benefit from the money saved by refunding – those who own the equity securities of the operating companies, or the rate paying public--or will they share in it on some equitable basis? It is easier to ask these questions than to answer them.

Another matter in which I am sure we are all interested is whether or not the consumer and investor can be served by requiring competitive bidding for security issues. I think before answering this question we have to agree on what we mean by “competitive”. If we have any difficulty in coming to such an agreement, we can certainly agree on what is not competitive. I believe there are very few arguments which can be advanced in support of the old indissoluble relationships between a company and a particular firm or group of investment bankers. The summer of 1936 saw in New England particularly a highly interesting working out of competitive bidding where the securities to be sold were put on the official auction block and were disposed of to the highest bidder. These cases, however, represented obligations of well-known companies which were merely undertaking the refinancing of outstanding obligations, secured by mortgages, the terms of which were well-known to the investment community. It is a question whether such a procedure would be equally advantageous to a less well-known company or where the amounts involved run into such large sums as to require the cooperative efforts of a large group in order to be successfully marketed. I think I may say that the Commission has so far reserved its opinion but it has insisted in all cases that the company make a showing that the field has been diligently searched and that the transaction to be approved has been the result of an investigation which was not limited to conversations with a single firm or group. In cases where the underwriter is also a large stockholder, the Commission makes a particularly searching investigation before approving a sale other than on the auction block.

In connection with proceedings concerning proposed issues of bonds and debentures, the Commission is sometimes able to supplement the work of State Commissions in the matter of indenture trustees having a substantial conflict of interest with the proposed holders of the securities to be issued. Frequently, this is a phase of corporate financing over which State Commissions have no jurisdiction and sometimes the relationship of the trustee to holding companies controlling the issuers voting securities is not readily available to State Commissions.

In one recent case, the proposed trustee was not only the largest holder of equity securities of the issuer's parent company but was also represented on the finance committee of the service company which had arranged for the proposed financing. The Commission, because of these conflicts of interest clearly indicated that it was reluctant to permit the issuance of the securities and that it did so only because under the circumstances of that particular case the re-negotiation of the issue would probably have caused the company and of course its security holders too much additional expense. the dissenting opinion took the position that because of the adverse interest of the proposed trustee and the fact that there had clearly been no competition in selling the issue to a group of underwriters headed by firms themselves having a substantial interest in the company's parent, the Commission should not permit the issue of these securities. As a direct result of these two opinions, the trustee in that case resigned and another trustee was appointed. The resigning trustee also evidenced his willingness to resign from similar situations in the same system.

It is often possible to avoid controversies of that sort by pointing out to the company in the initial stages of preparation for financing that the particular trustee under contemplation occupies such a position with respect to the issuer that an intensive consideration of the trustee's interest would be necessary before the Commission could consider its appointment as not being detrimental to the interest of investors and the public.

In another case, the proposed indenture trustee was already trustee under the mortgage of a sister company in the same system. The two companies were in the incestuous relationship of each owning substantial amounts of common stock for the other. In the event of default, the trustee would on the one hand be under obligations to protect the bondholders of the defaulting company to the extent even of moving to have all of its property applied to the satisfaction of the bonds, thereby reducing or eliminating the equity behind the bonds of the sister company. But remember, he is also trustee of the bonds of this sister company and so obligated to protect the interest of those bondholders. Such a duality of duty was clearly undesirable. The issuer had no difficulty in securing a trustee which would not find itself in such an embarrassing condition.

The experience of our Commission can be particularly helpful in connection with the sale of securities in matters of price and spread. State Commissions in the past have concerned themselves principally with a minimum price below which securities could not be sold. As a rule, State Commission's orders are obtained substantially in advance of the actual offering of the securities involved. The underwriters are naturally loath to commit themselves for a long period in advance of the actual offering date and consequently the price in the State Commission's order has necessarily had to be on the low side. A technique has been worked out whereby the orders issued under the 1935 Act are timed to coincide almost exactly with the effective date of registrations made under the 1933 Act. By so doing, the lapse of time between the banker's commitment and the date he is privileged to sell is reduced to a minimum. Furthermore, because we normally have a substantial number of other cases before us it is possible to form fair opinions on the questions of both price and spread in any particular offering. In some cases the final offering price range can be arrived at without again consulting the local commission involved in the case. In other cases, it has seemed desirable to consult with them before taking action. In those cases the local commissions have gladly availed themselves of the information at our disposal and have so modified their original orders. It is our hope that this splendid kind of cooperation between the Federal and State authorities will increase.

Last April I said to the savings banks' representatives in New York: "Laying Sections 11(a) and (b) to one side, since we have had virtually no experience under them, I feel that the sixteen months have shown that the Act is workable; that nothing in it interferes with the legitimate functions of the registered companies and their subsidiaries; that its operation has worked public benefits and will strengthen state regulation." To this I am prepared at this time to add only a brief comment. If the much cussed and discussed Section 11 were a "death sentence" then the action last week of the American Water Works and Electric Company, Incorporated, filing with us a plan for reorganization under this same Section 11 would be an application for permission to commit suicide. The implication of the statement issued by the management upon filing this application is that the proposed reorganization will add strength and vitality to the corporation. If the management is correct in its view, the term “death sentence” will be recognized as the misnomer it is, and Section 11 will be rechristened the “rejuvenation section”. But seriously, the most interesting aspect of the application is that the company believes it has worked out a plan which will comply with Section 11 without injury and even with benefit to itself. I think there will be more of these applications.

As I come to the close, I note that those in Washington who have helped me get together the material for this talk, have perhaps said too much about the things we can do for you. But I know, and I’m sure you know, that there are many, many things you can do for us. I’m not going to enumerate them now, but you can rest assured that you will hear about them from us time and again in the normal course of business in the future. In fact, some of you have already begun to hear about them. You may be assured that we have no desire to intrude upon that large province of supervision and regulation which is yours. We, in our turn would be glad of the assurance from you that we may enjoy your confidence in the interchange of ideas and information so much to our mutual advantage.

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