DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

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Subject: Division of Corporate Regulation

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Division of Corporate Regulation

MR. GARRETT. Today's Division is the descendant of what for many years was the Public Utilities Division. There was a time when work under the Public Utility Holding Company Act was sufficient to require a Division devoted to nothing but that, and I think in its peak it had something close to 250 employees. Several years back, however, it became apparent that work under the Holding Company Act was receding in volume because so many of the companies were getting themselves out of the Act for reasons I shall explain later. In 1949 the Commission's staff responsibilities, to the extent performed in Washington, under Chapter X of the Bankruptcy Act were transferred to the Division. Meanwhile work under the Investment Company Act was growing steadily and rather rapidly. The Investment Company Act work had originally been under Corporation Finance as was the work under Chapter X. But as Corporation Finance grew in size and as the responsibilities of the Public Utilities Division decreased in quantity under the Holding Company Act, the decision was made to transfer the regulatory aspects of the Investment Company Act over to the old Public Utilities Division and rename it the Division of Corporate Regulation.

The name "Corporate Regulation" is supposed to distinguish the Acts that we deal with as being regulatory in contrast to the 1933 and 1934 Acts, which are principally enforcement of disclosure as well, of course, as enforcement of antifraud provisions, etc.

In the basic role which we play in the regulation of the issuance of securities, the contrast between the 1933 Act and the 1935 Act is very marked in that when a company subject to the Holding Company Act seeks to put out an issue of bonds, disclosure is not enough. It must comply with the 1933 Act as an ordinary industrial company would, but it must meet other standards, and the Commission may find on the merits of the issue that the securities cannot lawfully be issued and refuse to allow them to be issued. That is a much more substantial power within that area than the Commission has generally under the 1933 Act where, as you know, a long line of Chairmen have never missed an opportunity to explain to the public that we don't pass on the merits of issues generally under the 1933 Act.

I won't dwell on the work of the Branch that deals with the Investment Company Act, since you have already had a session with Mr. Greene on that.

I should like to explain that our Office of Chief Counsel, which is reasonably new in the Division, has responsibility for a variety of things, but principally for the Division's work under Chapter X of the Bankruptcy Act. Let me explain what that amounts to:

Chapter X of the Bankruptcy Act was adopted back in 1938 to govern corporate reorganizations under the Bankruptcy Act in contrast to what is usually called straight bankruptcy. In straight bankruptcy the debtor, either under compulsion or voluntarily, confesses in court that he cannot pay his debts, the court, through a trustee, takes charge of the debtor, liquidates, and pays off the creditors in order of priority as far as the assets can go. When the trustee is through with that, the debtor individually is in the clear but the enterprise has usually disppeared as such. In corporate reorganization the intent and the aim is to reorganize the enterprise with a re-alignment of interests on the part of security holders and to keep the business afloat. The principal economic reason for doing that is that liquidation and sale of the assets piecemeal usually results in a down-valuing of the enterprise in contrast to its value if it is preserved and kept in operating form.

The most typical result of a corporate reorganization under Chapter X is, with rather elaborate procedures, for the security holders to end up with the old common stockholders out in the cold with nothing, with the preferred stockholders having a little bit of common, and the bondholders with common stock and perhaps a new issue of bonds sold to the public or sold to some other person coming into the enterprise. The general re-alignment of securities has junior persons in terms of priority and credit taking the worst beating.

These proceedings are complex and time-consuming, and when Chapter X was being drafted (and it was drafted largely as the result of a study conducted by the staff of the S.E.C. and headed up by the present Justice Douglas of the Supreme Court), there was considerable study given to the problem of who should administer the provisions of the Act. It was at one time even considered putting reorganization proceedings under an administrative agency, but eventually the jurisdiction was given to the United States District Courts. The decision, in large measure, was for practical reasons because the Federal Courts had experience in equity receiverships. However, S.E.C. was given an important role to play for the purpose of advising the courts. The ordinary Federal district judge has virtually no staff, as most of you know.

The S.E.C.'s responsibility is to advise the Federal Courts in two ways. Any reorganization proceeding under Chapter X ultimately culminates in a plan which is proposed by the trustee or some other person in interest. The court needs expert advice that is disinterested and independent on the merits of the plan. The S.E.C. gives the court that advice to the best of its ability. If there is more than $3,000,000 of aggregate indebtedness the court must refer the case to us for our advisory report on the plan. If there is less than $3,000,000, the court may refer it to us. If the court requests our advice, we almost always give it, though there have been occasions when we have declined to do so.

The other role that we play in Chapter X proceedings is to appear as a party -- not as a party in interest, we have no interest in these things from a financial or economic standpoint -- but as a party for procedural purposes to advise the trustee and to advise the judge on specific matters as they come up. We become a party only by leave of court. The court sometimes requests us to come in, other times we go to the court and ask for permission to come in. If the court asks us to come in, we almost always do so for obvious reasons. If we ask to get in, the judges almost always let us in.

Our decision whether to go in or not is based on size and public interest -- not entirely in terms of size, but a combination of the two. By public interest we mean the number of individual security holders involved. An enterprise may be rather large, but still involve just a handful of security holders, in which case we usually conclude that the public interest is not sufficient to justify our spending the time and manpower to participate on a day-to-day basis. When we do go into a case, we go into it quite thoroughly. We read every document that comes in, we take a position on almost every step that is being proposed before the court, with respect to things to be done with the bankrupt's estate and also (most notably as far as the Bar is concerned) we take a position on fees.

This work is not voluminous these days. There was a time when Chapter X work itself took a separate division. Since World War II there has not been enough of this type of thing to justify that kind of an elaborate staff treatment. The way we do the work is as follows: We have in certain Regional Offices, but not in all, a reorganization office. They exist in New York, in Chicago, in San Francisco, and Don Stocking in Seattle doubles as a reorganization man when necessary, but that is not his formal part. The offices are all small. In New York we have four or five professional persons, in Chicago four, in San Francisco just one lawyer, and in Seattle a part of one lawyer. As to the rest of the country, let me say that Chicago has the responsibility for the Denver region and the Fort Worth region on Chapter X matters. San Francisco has responsibility for the entire West Coast, the New York Office has the responsibility for its region, plus Pennsylvania, plus the Boston office's region. Work in the Southeast quarter of the country, in the Atlanta and Washington office regions, is done directly by our Division. This is based entirely upon work-load, and if the work-load increased, we would undoubtedly have to create more reorganization staff.

The present load, all told, is about 32 or 33 proceedings in which we participate actively. That doesn't sound like much, but, on the other hand, these matters take a lot of time and much effort.

The office of the Chief Counsel of the Division has a supervisory responsibility with respect to these regional offices. Whenever one of our Chapter X men wishes to take a position on some matter that has come up before the court, he sends his proposed position, together with his

reasons, to us. We review the recommendation. If we accept it, we send it straight down to the Commission and say, "everybody agrees," and hope that the Commission does, too. If we disagree, we do our best to iron out the disagreement with the regional office. If we cannot, this sometimes results in our asking their man to come to Washington and bring his files with him and have a knock-down, drag-out quarrel with them. If we cannot resolve our differences, the matter goes to the Commission and the Commission decides. We make an effort to distribute digests of actions that have been taken among the regional offices that are interested to keep them informed of what is going on. This tiny staff that we have devoted to Chapter X work is probably the principal source of learning and lore and practical experience on corporate reorganization in the whole country.

We also participate in an appeal if some one else takes an appeal. The Statute does not allow us to appeal from a decision of the District Court Court. If we do appeal, the case, as all of our other appeals, goes to the General Counsel's office. The Commission voted during the past year to seek the right to appeal, but the proposed legislation has not yet been introduced.

Turning to public utility regulation, I brought a chart that shows the various systems. As shown on this chart these are: The Electric Bond and Share System, which had several intermediate holding companies and was the largest truly holding company system at the time. The United Corporation has at least nominal control over more gross assets, but it existed principally to control financing and never operated as a unit in any sense at all, whereas the Bond and Share system was rather well organized as an operating matter as well as a method of financial control. There was also the Insull system, Commonwealth and Southern system, Associated Gas and Electric.

The Holding-Company Act provides, among other things, in Section 11 that every registered holding-company should reduce itself to a single integrated system with a simple and reasonable corporate financial structure, in effect. That was the basis of Section 11(b), which was the so-called "death sentence" as it was then known in the industry and on the Hill. This was a misnomer because first of all it didn't kill the companies in the sense of putting the operating companies out of business. They are all still in existence and thriving. It did kill unnecessary and unjustifiable holding-companies as distinguished from operating companies. But there still exist very substantial holding-companies, both registered under the Act and exempt from the Act, as I will show you in a moment.

The Section 11 process was to require each of these holding-companies systems first to register under the Act, using the technique of the 1933 Act, so that the result, so to speak, in the 1935 Act is all in terms of making it unlawful to do business without registering. Once registered, they got hooked for all sorts of other things, too.

Once registered, they then had to comply with Section 11. Specifically they had to reduce themselves to a single integrated system with a simplified capital structure and fair voting arrangements. They could do it by order of the Commission or by a voluntary plan. What happened in most cases was that the Commission would start a proceeding to determine whether a particular system complied with Section 11(b) and then would issue an order saying that only so much of its properties, if any of them, may be regarded as part of an integrated system and the company must get rid of the rest, and that its capital structure had this or that defect according to the standards of the Act. Then the company itself would propose a reorganization plan. We speak of it as an 11(e) plan because Paragraph (e) of Section 11 provides for this plan procedure. Once we got into the 11(e) stage, with the order under 11(b) as the guide, so to speak, the case then much resembled a bankruptcy reorganization: you had a plan, and you had court authority to re-align the rights of the security holders within the corporate structure, and also to compel divestment of properties, though we would normally let the method of divestment be up to the company involved.

The result was that the principal active electric holding-company systems registered under the Act at the moment are: The American Gas and Electric, the Southern Company, Middle South, Central and Southwest, West Penn, General Public Utilities, Delaware Power and Light, New England Electric System, Utah Power and Light, and Eastern Utilities Associates.

We also regulate gas companies. And I should explain that "public utility" in the Public Utility Holding-Company Act means an electric generating, transmitting, or distributing company, or a gas distributing company, whether natural or manufactured. In 1935 most gas was manufactured. The long-distance transportation and distribution of natural gas was still largely a dream. There were a couple of long-distance pipe-lines at that time, but very few. But the Act clearly covers natural gas. Note, however, that it does not include the production or transmission of gas, only the distribution at retail. That is important because there are tremendous interstate pipelines in operation in the natural gas business which are not under our Act and were carefully excluded by definition. It is somewhat illogical to keep them out, but there were apparently valid historic reasons for doing so at the time.

The gas systems which we have as registered systems are four: the American Natural Gas system, Columbia Gas System, National Fuel Gas, and Consolidated Natural.

We have over registered companies first of all what I would call Section 11 jurisdiction, that is, the duty and the authority to require them to reduce themselves to a single integrated system plus whatever businesses they can justify under the rather strict standards set out in the Act. We then, because of their registration, have jurisdiction over all their financing. Utilities do a very large proportion of the registering of securities in any given year under the 1933 Act. It is somewhere in the neighborhood of 30%. They have to file a declaration under the 1935 Act before they can issue securities. This declaration has to contain certain information, and the Commission must find that certain standards in the Act have been met. That gets us intimately involved in the provisions of bond indentures, the protective provisions for the

bondholders, for example, with respect to such detailed matters as depreciation requirements, replacement and renewal requirements, the freezing of surplus, or rather the prohibition against the paying out of too much funds in dividends, and the limitation as to the bonding of property additions, etc. We have a very detailed statement of policy applying to bond indentures issued under the Holding Company Act. We have a similar statement of policy with regard to the preferred stock charter provisions. Some of the most shocking things were committed in the last 20 years against preferred stock.

We are intimately concerned with the capital structures of our registered systems. There is, for tax reasons and rate reasons, a strong temptation to increase the bonded indebtedness on utility companies. Bond interest is deductable tax-wise, and because of that you can at any given moment usually figure a lower rate by imagining a higher proportion of your total capital in bonds rather than in common stock or preferred. We think too much of that is short-sighted. We try to persuade the companies to keep their equity up and not fall into the temptation of selling too many bonds.

As to any other corporate changes: If they want to change the charter in any respect, if they want to acquire more utility assets, if they want to merge a couple of their system properties--anything of significance in the corporate operation of the enterprise, has got to be approved by the Commission. The approval has to be of a formal character, which means the issuance of notice of the pending transaction, an opportunity for bearing if anybody requests it, and if they do, a full-blown administrative proceeding.

We also have a certain jurisdiction over a large number of companies that are exempt from the Act by order of the Commission. You will find the exemptions all listed under Section 3(a).

An exempt company is one which qualifies under the formal standards set out in one or more of the various subparagraphs of Section 3(a), and also meets what we call the "unless and except" clause. This means that even though it meets the formal requirements, it can be exempted only unless and except insofar as we find the exemption detrimental to the interest of investors and consumers or the public interest. One of the formal requirements, for example, is that all of the utility subsidiaries are abroad. American & Foreign Power Co., which is about a billion dollar operation, owns electric utilities all over South America. It is a subsidiary of Bond and Share and is an exempt holding-company because Section 3(a)(5) says that you can get exempt if all of your utility properties are outside the United States, unless and except, etc.

Another reason for an exemption is that you are primarily an industrial company and only incidentally run a generator, for example. A surprising number of companies are exempt under that paragraph, including U. S. Steel, General Electric, Ford Motor Co., and a large part of American industry.

Another basis for exemption is to be wholly intrastate. Another basis for exemption is to be predominantly an operating company in a single state or contiguous states and, in effect, only incidentally a holding-company.

One processing of exemption applications is at times an important part of our business. Also, we have a certain residual power over such companies because Section 3(c) enables the Commission to re-examine an exemption once granted if it finds there has been a material and relevant change in the basic facts. We have done that only a few times. We have threatened it more times than we have done it--the threat has usually been effective. But is means that we have got to keep an eye on things, even though we have granted an exemption, to see whether the facts have changed in a way that should require us to re-examine something about the company which might take away their right to an exemption. That is our business under the 1935 Act. Our regular stock in trade is the processing of financing. The things that take up most of our time are the bond issues and less frequently the common stock issues that come in. They are to some extent routine, but not entirely. There always seem to be new problems, one of which, right now, is the question of redemption premiums. Because bond interest rates are high, institutional purchasers of bonds are more and more anxious to get the issuers locked in. They want the issue, ideally, to be non-callable so that they can sit on this 5% interest for the life of the bond. An electric utitliy bond is almost always 30 years. From the utility's point of view and from the consumer's point of view, that is terrible. If the interest rate goes down, they ought to be able to re-finance to take advantage of the cheaper money.

We have continued to insist upon low call premiums. You always pay a little bit to call in the early days of the bond. By "call" I mean to call the bond in and pay it off. But we have resisted successfully so far any attempt to make the bond non-callable or to put on so high a call premium as to make it practically non-callable. Our legal power to resist is obvious, but we cannot exercise it to the point of preventing utilities from being able to finance at all. They have to have money to expand. So far they have been able to comply with our requirements as to call premiums and get money at as good rates as anybody else.

We have a pamphlet which comments on a bill that was introduced last year which would have amended the Holding Company Act in certain respects. One respect had to do with its application to atomic energy power projects. With respect to that there is an article in the May 23 issue of Public Utilities Fortnightly by the former Chairman, J. Sinclair Armstrong.

There was also another amendment seeking to exempt a group of companies out in the Pacific Northwest that has in mind a very large hydroelectric project. We opposed both, and in the process of commenting and explaining our position to Congress, committed a rather comprehensive and detailed explanation of what we do under the Statute, with lists of companies that have been exempted, and various other things. I recommend this to you for your reading. Another source of outside reading, of course, is the Annual Report.