

REGULATION OF THE HOLDING COMPANY UNDER THE  
FEDERAL PUBLIC UTILITY ACT OF 1935

Address of Commissioner George C. Mathews  
of the  
Securities and Exchange Commission

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Prepared by I. N. P. Stokes, II, and Commissioner Mathews.

In a discussion of "Regulation of the Holding Company under the Federal Public Utility Act of 1935", it may be well to begin by pointing out some of the things with which this lecture is *not* concerned.

I am not going into the history of the various abuses which have characterized the finances of many public utility holding companies. I am sure that you are all aware, to some degree, of these. Nor do I propose to offer any detailed discussion of the merits of the legislative policy underlying the Holding Company Act as a means of dealing with these abuses. Finally, it is not my intention to argue the question of the constitutional validity of the statute. As you know, this is now being litigated. Meanwhile, it is the function of the Commission to administer the Act on the assumption that it is valid in every detail, while recognizing, of course, the right of the industry to contest this assumption in appropriate judicial proceedings.

Taking the Act as we find it, I propose to examine with you the objectives which it seeks to accomplish and to explore some of the many problems which will face the Commission in its administration and will confront the industry in adjusting itself to Federal regulation.

At this time it is obviously impossible to discuss the methods by which the Commission will carry on its work or what its conclusions will be as to the many problems to be presented. About all that I can undertake is to make some explanation of what the law provides and of what the Commission's duties will be.

It may be helpful to outline the Commission's functions under the Securities Act and the Securities Exchange Act in order to point out the difference between them and the new task with which the Commission is confronted.

The Securities Act of 1933 requires, with certain exceptions, the registration with the Commission of securities which are sold to the public through the mails or in interstate commerce. Many utility companies have filed registration statements, but, under the Securities Act, the Commission has no jurisdiction to deny registration on the ground that an issue is not a reasonable addition to the capital structure of a company, or that the terms on which securities are offered are unfair to any class of investors. Its only function is to make sure that certain information regarding the security and the issuer is made available to

the public. Of course, publicity tends to discourage some of the more flagrant abuses, but many registration statements, not limited to those of utility companies, reveal continuing financial practices which may be severely criticized.

Under the Securities Exchange Act of 1934, the Commission is given extensive authority to regulate the business of dealing in securities, but here also its powers over the companies whose securities are traded in on the market are essentially limited to requiring the disclosure of adequate information for the guidance of investors.

In administering the new legislation, the Commission will be charged with the duty of actually preventing certain practices in corporate finance and of regulating others, instead of merely compelling their disclosure to the public.

The general purpose of the Public Utility Act of 1935 is to give to the Federal Government power to regulate public utilities in certain respects insofar as State regulation has been found to be inadequate. It is intended to supplement but not to supercede State regulation. That there have been many abuses not subject to effective control by the States has been admitted, even by many of the interests which opposed this legislation. Recent improvements in standards of utility financing, following upon the investigation by the Federal Trade Commission and the collapse of many financial structures, might not be entirely lost in the absence of the regulation imposed by this Act, though what might take place with returning financial opportunity I cannot say. I am not credulous enough to believe that self-regulation, in response to public criticism and financial embarrassment, would alone suffice. Of course, we cannot say that the possibilities of dealing with the problem through action by the States have been exhausted, but there are certain fundamental handicaps which, as a practical matter, make an adequate solution of the problems on a basis of State regulation out of the question. I need not speak of the political obstacles in the way of adequate or uniform legislation and of effective administration. Even without jurisdictional limitations, those would be serious, but there are certain very real limitations on the power of an individual State to deal with interstate business and with holding companies organized in other States.

✓ The Public Utility Act of 1935 is divided into two titles. Title I, which is termed the "Public Utility Holding Company Act of 1935", is that which I propose primarily to discuss. In general, it gives the Securities and Exchange Commission power to regulate the financial practices and corporate organization of public utility holding company systems. Title II consists of amendments which greatly expand the powers given the Federal Power Commission by the Federal Water Power Act of 1920. It is concerned only with operating companies which are licensees using water power on streams subject to the jurisdiction of the Federal Government, or are engaged in transmitting electric energy in interstate commerce or selling it at wholesale in such commerce. The Federal Power Commission is given authority, roughly similar to the Interstate Commerce Commission's authority over railroads, to regulate rates for the transmission of electricity in interstate commerce and its sale in interstate commerce, as well as to prescribe accounting methods to serve as a basis for such rates. The Securities and Exchange Commission is given no power to regulate rates. The Federal Power Commission also has certain powers with reference to the inter-connection and coordination of operating facilities and, in the case

of companies which do not come under the jurisdiction of the Securities and Exchange Commission as members of holding company systems, a measure of control over the issuance of securities, mergers, sales of assets, banking affiliations, and similar matters. ✓

I shall attempt to describe the sort of problems which will arise under Title I, which we may refer to as the "Holding Company Act", and, here and there, to point out the meaning of the statute where it may not be clear to those of you who have not had time to give it extensive study. I think it should be definitely understood that what I say to you in the course of this discussion is in no sense an official interpretation of the Act. Of course, every bit of legislation, no matter how carefully drawn, is susceptible of different interpretations in its application to many individual instances, and our experience with the Securities legislation has impressed us with the great difficulty of the many problems of interpretation. I can only give you my personal and somewhat offhand understanding of the law as I see it at this early stage of its administration. Likewise, I trust you will appreciate that anything I may say as to the policy which may be pursued by the Commission is to be taken only as my tentative, informal reaction, and not as the considered judgment of the Commission.

The first section of the Act contains a recital of the abuses which have characterized many public utility holding company systems, and explains their relationship with interstate commerce. Although a recital of this sort, which has been termed by some people a "stump speech", may seem incongruous as a part of legislation, I understand that lawyers feel that the need for it has been clearly indicated by opinions in which the Supreme Court has said that the basis on which Congress purports to exercise Federal jurisdiction must be clearly indicated.

To understand the scope of the Act, we must keep in mind some of the definitions contained in Section 2. The Act applies primarily to public utility holding companies and their subsidiaries. Public utilities, for purposes of the Act, include only electric and gas utilities. The first definition which we should examine in detail is that contained in Section 2(a)(3), defining an "electric utility company" as a company which owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale, other than sale to tenants or employees of the company. Of course, there are many cases of industrial companies which produce electric energy primarily for their own consumption, but sell a certain excess to the public. Although the definition of an electric utility company is broad, the statute expressly directs the Commission to exclude from the category of electric utilities, companies which it finds to be primarily engaged in some other business and where, by reason of the small amount of electric energy sold by them, it is not necessary in the public interest or for the protection of investors and consumers to subject them to regulation as electric utility companies. This is provided by clause (A) of Section 2(a)(3). It is also provided by clause (B) that the Commission shall exclude from this category electric operating companies, which, although not engaged primarily in some other business, are intrastate and wholly owned subsidiaries of manufacturing companies, to whom they sell most of their output.

The next definition, in paragraph (4) of Section 2(a), is that of a "gas utility company". You will note that this is somewhat narrower than the definition of an electric utility company in that it includes only companies which own or operate facilities for the distribution, at retail,

of natural or manufactured gas, and does not apply to gas production or pipeline companies as such, although the logical basis for the limitation of the definition is not apparent. The Commission is given an express direction, corresponding to that in Section 2(a)(3), to exclude companies which are primarily engaged in some other business.

The most important definition is that of the term "holding company", which is to be found in Section 2(a)(7). The obvious purpose is to bring within the definition companies which have control over others. You can well appreciate that it is practically impossible to prescribe a simple test distinguishing a holding company from a company which merely owns a large interest in another, without either leaving out a great many companies which we all recognize as holding companies or including companies which, though they hold large stock interests in utilities, are not, as a matter of fact, in a position to exercise real control. On the one hand, there must be a fairly definite standard which can be applied by members of the industry and their lawyers, without besieging the Commission with endless requests for opinions or rulings in individual instances. On the other hand, the definition must be sufficiently elastic so that the Commission may bring within its jurisdiction companies which actually control utility assets without a substantial stock ownership and exclude those which have extensive stock ownership without control. To meet this twofold difficulty, the definition of holding company provides three standards. Clause (A) states that any company which controls 10% or more of the outstanding voting securities of a public utility company is, prima facie, a holding company. Clause (B) gives the Commission power, after adequate notice and opportunity for hearing, to determine that a company is to be treated as a holding company actually controlling a public utility, although its stock ownership represents less than 10% of the voting power. Thirdly, in order to furnish adequate elasticity in the opposite direction, the Commission is directed to exclude from the category of holding companies, companies which, although holding a 10% voting interest in a public utility, do not thereby exercise a controlling influence over the management or policies of the company, so as to make it necessary to bring them within the scope of regulation.

The next subdivision, Section 2(a)(8), contains a definition of "subsidiary company", which is the converse of the definition of holding company. In other words, any company, 10% of the voting securities of which are controlled by a holding company or a subsidiary of a holding company, is, prima facie, a subsidiary company, but the Commission can include companies which are actually controlled by a smaller percentage of voting power and exclude companies which are not controlled by a specified holding company, in spite of the fact that the latter holds 10% of the voting securities.

There are certain other important definitions in Section 2 which, I think, had better be discussed later, when we get to the provisions of the Act primarily concerning them.

The scope of the Act is made flexible, not only by the Commission's power under Section 2 to exclude certain companies from the categories of

public utility companies, holding companies, and subsidiaries, but by Section 3, which provides for exemption of certain companies, even though they are found to be holding companies or subsidiaries of holding companies. Section 3(a) indicates quite specifically the types of holding companies which the Commission is authorized and directed to exempt, except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers. In the first place, holding company systems which are substantially confined to a single State, in which all the companies involved are organized, are to be excluded. The entire system, in such a case, can be regulated adequately by the State. Paragraph (2) provides for exemption of holding companies which are only incidentally holding companies, being primarily operating companies operating in the State of organization and contiguous territory. The corporate activities of such companies, which may have a few minor subsidiary operating companies, are not apt to be characterized by the practices which are sought to be eliminated by this legislation. Paragraph (3) affords exemption to holding companies which are primarily engaged in manufacturing or other non-utility businesses, and whose utility subsidiaries either represent a very small proportion of their business or have no securities outstanding in the hands of the public so as to necessitate protection of investors.

It sometimes happens that a company takes over securities of a utility in settlement of a debt or as collateral for a loan. Such an acquisition is not normally made for purposes of controlling the utility, and the company gets rid of the securities as soon as market conditions permit. Obviously, a company of this sort is not, generally, the type which should be regulated as a holding company, and paragraph (4) of Section 3(a) provides for its exemption. So, also, any large underwriting house distributing an issue of utility stocks might, in the course of such distribution, own a 10% interest for the time being, and the Commission is likewise directed to grant an exemption.

Finally, Section 3(a)(5) indicates that public utility holding companies whose activities, as such, are confined to foreign countries, are to be exempted from regulation.

It is important to note that, although the Commission is directed and not merely authorized to exempt holding companies of the types which I have been discussing, it may retain such jurisdiction as seems necessary to prevent abuse. It might, for instance, be desirable to retain some control over security issues, even though control over all the activities covered by the legislation were not found necessary.

Foreign subsidiaries are apparently deemed beyond the intended scope of the Act for many purposes, and provision is accordingly made in Section 3(b) for their exemption.

One of the first tasks which confronts the Commission in its administration of the Act is the handling of applications for orders excluding companies from the definitions of electric and gas utility companies, holding companies, and subsidiary companies under Section 2, and for exemptions pursuant to the provisions of Sections 3(a) and 3(b).

The statute contains somewhat unusual provisions with respect to these applications: if a company applies in good faith, it automatically receives the status applied for, until and unless the Commission otherwise decides. This protects the applicant against the delay which is often complained of in the case of proceedings before administrative bodies. On the other hand, it is obviously desirable that the Commission pass on such applications promptly so that they may be settled on the merits. This means that it must have before it adequate information to determine whether the conditions specified in the statute are present in the particular instance. Merely to invite companies to make application in any manner they may deem fit, and subsequently to obtain the information required, by hearing or by an interchange of correspondence, would obviously involve too much delay and might impose a real hardship on companies who go to the trouble of submitting information which the Commission might deem irrelevant. On the other hand, there simply is not time to prepare a set of detailed questionnaires which would indicate precisely the information desired. Moreover, even if there were time to prepare such questionnaires, they would probably be undesirable, since, in order to make them adequate in some cases, it would be necessary to include many questions which would be useless, and therefore burdensome, in others. The Commission is, therefore, adopting a policy midway between that of considering each application on an entirely individual basis, without indicating in advance the general type of information desired, and that of specifying in detail the information to be given. The rules which have been published under Sections 2 and 3 indicate, as precisely as possible, the information which is to be given, but each of these rules is subject to the very important provision of Rule 3, part of which I would like to read to you:

"Applications for orders pursuant to Sections 2 and 3 should contain substantially the information specified in the appropriate rule. If, however, any such information is not available without unreasonable effort or delay, or is deemed by the applicant to be irrelevant to the question presented, the applicant may omit such information, briefly indicating the reasons for such omission, and submitting instead such other information, if any, as it may deem relevant..... If any applicant is in doubt as to the interpretation of any requirement of the appropriate rule under Section 2 or 3, it should, in making its application, adopt the interpretation which seems to it most reasonable, and expressly explain the interpretation adopted. All applications shall be subject to the right of the Commission to require any additional information, whether specified by the appropriate rule or not, as it may find necessary or appropriate in the particular case. The applicant may at its option include any additional information not required by the Commission."

In this way, we are endeavoring to reduce red tape to a minimum.

~ You may have noticed that, in determining whether a company is a public utility and in granting exemptions under Section 3(a) and (b), the Commission is authorized to act not merely by order in individual instances, but by rules and regulations of general application.

So far, the Commission has not felt prepared to proceed by general rules or regulations in this connection. The reason for this is not hard to see. Practically all of the categories of electric and gas utilities, holding companies, and subsidiaries which the Commission is directed to exclude from the operation of the Act, are described in somewhat general terms, such as "primarily engaged" in other businesses, "predominantly intrastate", "temporarily a holding company", and so forth. It is obviously desirable that these standards should be sufficiently elastic to make sense in their application to various situations which cannot be foreseen in advance. Although it is possible that the Commission might be able to exempt some whole classes of companies by a more or less arbitrary grouping, such as, for instance, saying that companies which derive less than a specified percentage of their revenue from interstate operations shall be deemed "predominantly intrastate" in character, the practice of proceeding only by order in individual instances has the important advantage that it permits each company to know definitely where it stands, without having to rely on its lawyers' interpretation of the Commission's rules.

The most important provision for flexibility in administration of this legislation is contained in Section 3(d), which permits the Commission, by rules and regulations, conditionally or unconditionally, to exempt classes of subsidiaries and affiliates from one or more provisions of the Act. The standard by which the Commission is to be guided in acting under this provision is merely the public interest and the protection of investors or consumers, subject to the express direction that the exemption must not be contrary to the purpose of the Act. Of course, no matter how much care is given to the drafting of legislation, there are bound to be many instances where it will have an effect unforeseen even by those who have tried to present every possible argument against its passage. On the other hand, if an administrative body is given complete discretion in the enforcement of a statute, there is too great a danger that it will be accused, rightly or wrongly, of favoritism and of yielding to political considerations. Thus, in the case of holding companies, the exemptive power of the Commission is very carefully limited to the types of situation which were brought to the attention of the Senate and House Committees as deserving of relief from the burdens of regulation and not coming within the essential purpose of the statute. When it came, however, to the detailed application of the statutory provisions to the almost countless subsidiaries and affiliates of our holding company systems, it was obviously impossible to foresee and classify, in statutory language, all the situations where complete or partial exemption might be desirable. The Commission was therefore given extremely broad power to mitigate or completely to preclude the application of the statute in instances where subsidiaries or affiliates are involved.

The provisions which I have so far discussed indicate what companies come within the jurisdiction of the Commission as holding companies and their subsidiaries, and the discretion which is granted to the Commission in broadening or narrowing the field of regulation. We may now take up the various aspects of regulation to which a company is subject once it comes within this class.

First of all is the process of registration which is essentially a formal action identifying a holding company and its subsidiaries as being within the scope of the Commission's jurisdiction. Section 4 provides for registration by December 1, 1935, and Section 5 spells out the manner in which registration is to be obtained. A simple procedure is afforded whereby a company is to be registered upon receipt of a notification of registration, to be supplemented at a later date by more detailed statements which the Commission will by then have time to prescribe.

The first important respect in which a registered holding company and its subsidiaries are subjected to regulation, is the issuance of securities. You will recall that, under the Securities Act of 1933, the Commission is authorized merely to require adequate disclosure. Under Sections 6 and 7 of the Holding Company Act, certain restrictions which will materially affect the nature of the securities and the financial practices of the issuer, are imposed upon the issuance and sale of securities. Section 6 provides, in general, that no registered holding company or subsidiary thereof may issue a security unless it has filed with the Commission a "declaration" regarding such security, and such "declaration" has been ordered effective by the Commission. Certain exemptions are provided for short term paper, securities of subsidiary companies issued to finance their utility operations and expressly approved by State Commissions, securities of subsidiaries which are not holding companies, public utilities, or investment companies, and securities which are issued pursuant to warrants or conversion privileges already outstanding.

Subsection (c) imposes limitations on the methods by which the securities of holding companies are to be sold. They may not be sold from house to house, and they may not be sold through officers or employees of subsidiary companies. I think most of you are aware of the practice which was developed by some of the large holding companies which compelled their operating subsidiaries to have their employees, such as meter readers and filling station attendants, who were not familiar with financial matters, sell securities to any customers they could secure.

The procedure for filing a declaration with respect to a security issue, and the standards which the Commission is to follow in determining when to permit the declaration to become effective are set out in Section 7. The issuer must file with the Commission a declaration, setting forth information about the issuer and the issue, in manner and form to be prescribed by the Commission. Although the Commission's forms for use under this Section have not yet been promulgated, they will probably be similar in many respects to those used under the Securities Act of 1933, except that certain additional information will have to be required to enable the Commission to determine whether the security meets the standards which are provided in the statute. It may be appropriate here to speak briefly of those standards.

Subsection (c) indicates the type of security as to which the Commission may order a declaration to become effective. There are a number of alternative tests, one of which must be satisfied. Since the manner in which these tests are set out in the statute is rather confusing, I shall restate them in what may be a more logical order:



The primary principle is that holding companies should not normally issue no-par stock, preferred stock, or unsecured debentures. Absence of par value has often served to conceal write-ups and mislead the investor as to the sums actually invested in the enterprise. When a member of the public purchases preferred stock or a bond, his natural assumption is that he is getting a security which is in a preferential position as to earnings. But in the case of holding companies, this is true only in a technical sense. The preferred stockholders and unsecured debenture holders of a holding company often have merely differing degrees of right to dividends received by the holding company on the common stock of operating companies. If the issuer is not a holding company, or if the security is issued for the purpose of financing its business as an operating utility, these objections lose their force, and the statute permits approval by the Commission. It is also recognized that, in the course of refinancing operations, mergers, reorganizations, and similar financial readjustments, there will often, as a practical matter, be no choice but to issue securities of the general type already outstanding in the hands of investors. The Commission is given the further power to disregard the limitations which I have just discussed if, in urgent cases, they would impose an unreasonable financial burden on the issuer, or if the issuance of the security was authorized before January 1, 1935. The Commission may also permit the issuance of guaranties or assumptions of liability on other securities, and receiver's or trustee's certificates.

The security must not only be of a specified type, as indicated in subsection (c), but its relationship to the general corporate structure must meet certain standards which are set forth in subsection (d). It must be reasonably adapted to the general security structure of the company and the remainder of the holding company system. By this standard, general though it may be, it is apparently expected that the Commission may prevent the issuance of securities which would only have to be eliminated in meeting the requirements of simplification of holding company structures contained in Section 11, which I will discuss later. Secondly, issuance of the security must not be permitted if it is not reasonably adapted to the earning power of the declarant. In the Bill as originally introduced, the test imposed was that the security must bear a reasonable relation to the sums prudently invested in the system. The difficulty of making a finding as to the sums prudently invested must be apparent. State Commissions have found it impossible to determine the amounts, in many cases. The test of earning power does, however, permit the Commission to veto an issue which promises dividends or interest rates obviously beyond the power of the system to maintain with any reasonable assurance. In the third place, an issuance is not to be permitted if it is not necessary or appropriate to the economical and efficient operation of a business in which the applicant is lawfully engaged. Paragraph (4) gives the Commission power to require that fees, commissions, and other remuneration involved in the issuance and sale and distribution of the security should be reasonable. This is obviously designed to afford protection against the bankers taking more than a reasonable share of the proceeds, and to insure against holding companies themselves milking their subsidiaries by excessive charges for financing. Paragraph (5) provides against excessive guaranties or assumptions of liability, and paragraph (6) gives the Commission general power to reject terms and conditions which are unfair to the public.

The Commission's jurisdiction extends not only to the issuance of new securities, but also to the exercise of any privilege retained by the company to alter rights of the holders of an outstanding security. For example, at least one of the large holding companies has issued bonds convertible into stock at the option of the company. In exercising such an option, such

a company would now have to file a declaration with the Commission, and, as provided in Section 6(e), the Commission could withhold approval if the change were found to be detrimental to the interests of investors.

The Commission is given power, under subsection (f), to impose specific conditions which will prevent evasion of the purposes of this section after a declaration has become effective.

Let me refer you specifically to subsection (g), which gives the State Commissions the right to protest to the Securities and Exchange Commission in case any proposed issue is in contravention of State law, and directs our Commission, in such case, not to permit the issuance until and unless it is satisfied that the requisite law has been complied with. The problem of cooperation with the State Commissions is one of the most important, from an administrative point of view, with which the Commission is faced. In this connection, I might call your attention to Section 21, which makes it clear that the Act is not intended to derogate from the power of the State Commissions except in such rare instances as might arise where the provisions of State law are inconsistent with those of the statute or the Securities and Exchange Commission's rules and regulations. In general, compliance with requirements of Section 7 will not excuse an issuer from obtaining the consent of State authorities where this is required by State law. In fact, the State Commissions can insist that their requirements be satisfied before a Federal clearance is given.

Before taking up our next major topic, we may note, in passing, Section 8, which precludes the use of the holding company device to evade State laws regarding the control of gas and electric facilities by the same companies. This is achieved by making it unlawful for a holding company to acquire interests in gas and electric properties where the State law would not permit the same operating company to run them both, unless the State Commission expressly has authorized the holding company's acquisition.

If regulation of holding company systems is to be effective, the Commission must obviously have power to supervise any further growth of the systems which are under its jurisdiction. The subject of acquisition of utility assets, security holdings, or any other interest in any business, is covered by Sections 9 and 10. Although the general policy of the Act, as more particularly illustrated by the so-called "death sentence" is clearly against the uncontrolled expansion of holding company systems, there are bound to be many cases where the transfer of operating properties or security holdings as between systems will be essential to the consolidation and simplification which the Act seeks to attain.

The Commission's jurisdiction in this respect is established by Section 9(a), which subjects to the approval of the Commission acquisitions on the part of registered holding companies or their subsidiaries of the assets of other companies, securities of other companies, or any interest in any other business.

Paragraph (2) of Section 9(a) requires such approval also in the case of acquisitions by companies which, although not registered holding companies or subsidiaries, are in a position to become holding companies by gradually building up control. You will note that, in order to come within the operation of Section 9(a)(2), the acquiring company must, after the acquisition, be an affiliate of two public utility or holding companies. The term "affiliate" is defined in Section 2(a)(11), but, for our present purposes, it includes only a company which controls 5% of the voting power of the company in question.

Since it is not by its terms confined to registered holding companies and their subsidiaries, and consequently ineffective until such registration, Section 9(a)(2) is the one provision of the Holding Company Act which became practically effective immediately upon enactment. As the Commission is not yet in a position to promulgate the necessary rules and regulations for enforcement of this provision, it has made use of its general exemptive power as to affiliates under Section 3(d), and has postponed the effect of Section 9(a)(2) until further notice, subject to the condition that acquisitions coming within its scope must be reported to the Commission.

Certain exemptions from the necessity of Commission approval of acquisitions are provided by Section 9. Acquisitions of utility assets by an operating company are exempt if expressly authorized by a State Commission, and acquisitions of securities by operating companies so authorized are likewise exempt if the acquiring company and the other companies in the system are substantially confined in their business to a single State in which they are organized and provided further that the company whose securities are acquired is already an operating subsidiary of the acquiring company. Subsection (c) provides for the exemption of securities acquired primarily with a view to the investment of funds or in the ordinary course of business as distinct from major moves for the extension of control or the expansion of business.

The tests which the Commission must impose in determining whether or not to approve an acquisition are set out in Section 10. These tests are not quite as specific as those in the case of security issues and will, of necessity, require that the Commission exercise more particular judgments on the merits of individual cases. I will omit a detailed discussion of Section 10(a), which merely specifies the sort of information which the Commission may require as a basis for action. In general, subsections (b) and (c) direct the Commission not to authorize acquisitions which will unduly complicate the system, or which will be contrary to the obvious intent of the whole statute and to the particular policy set forth in Section 11, which deals with the simplification of holding company systems and their confinement to integrated systems. The Commission is also authorized, by subsection (e), to scrutinize the reasonableness of the consideration to be paid and the various fees and commissions involved. As you are well aware, one of the most flagrant abuses of the holding company device has been the practice of some holding companies in buying properties and reselling them, at an excessive profit, to their subsidiaries. Under the Holding Company Act, the subsidiaries would have to apply for permission to the Commission and the Commission could examine the propriety of the prices involved, although to do this within any close limits will undoubtedly be very difficult. State laws must also be complied with, except where the Commission finds that this would interfere with carrying out the provisions of Section 11.

I come now to that aspect of Federal regulation which has attracted the most widespread popular attention. I refer to the program for gradual reorganization of many of our holding company systems, with a view to regrouping the various units along lines of operating integration which are dictated by practical efficiency. The Commission's duties in this respect are outlined in Section 11, which I should like to discuss in some detail.

Section 11 was the subject of bitterest controversy during the many months when this legislation was before Congress. It is the form in which the so-called "death sentence" was enacted. In the course of the opposition which was developed to the Holding Company Bill, the voluminous material which was sent out to the stockholders of many utility companies

was concerned primarily with the disastrous effects anticipated from the "death sentence". Since there has been so much public discussion of this provision in the form in which it was originally introduced and relatively little publicity with regard to the solution finally adopted, I think it might clarify matters if I go back over the evolution of this part of the Act.

In the Bill as originally introduced, the Commission was directed to bring about eventually the complete elimination of *all* public utility holding companies controlling systems in more than one State in this country, with the single exception that, where State laws made it impossible for the same operating company to operate in contiguous States, unified control could be continued by a holding company owning such operating companies. As passed by the Senate, Section 11 contained substantially the same feature, although it was somewhat less stringent than the original Bill in other respects, and was subject to the Commission's limited powers to exempt holding companies, which I discussed in connection with Section 3(a). The Interstate and Foreign Commerce Committee of the House of Representatives greatly modified the Bill before reporting it to the House, only requiring that the Commission should make each holding company confine its activities to a single integrated system, or to such number of additional integrated systems as the Commission should deem consistent with the public interest. A move to reinsert the Senate version of the "death sentence" on the floor of the House was defeated. As finally passed, the section represents a modification of the Senate version.

Section 11(a) directs the Commission to make a study of the entire problem of eliminating undue complexities in holding company organizations. The action which the Commission is to take in order to simplify holding company systems is specified in subsection (b). Under paragraph (1) of this subsection, the Commission is directed, as soon as practicable after January 1, 1938, to require each holding company to limit its operations to a single integrated system, subject to exceptions which I will discuss in a moment. The term "integrated public utility system" is carefully defined in Section 2(a)(29). Permit me to read to you this definition as applied to electric utility systems:

"As applied to electric utility companies, a system consisting of one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation."

There is a similar definition with respect to gas utility companies, except that physical interconnection is not an essential factor.

Thus, save in exceptional cases, it will eventually be impossible for the same interests to control public utility systems which are not part of the same geographically and economically integrated unit. The Commission may, however, make exceptions in cases where it finds that retention of additional systems under the same control cannot be avoided without the loss of substantial economies, provided that additional systems so included are confined to a single area, and that the resulting holding company system which is permitted to continue will not be so large as to impair the advantages of localized management, efficient operation, and effectiveness of regulation. In bringing about this integration, the Commission must also require holding company systems to confine their activities to the public utility business and to such other businesses as may be found reasonably incidental. In effectuating this policy, the Commission will have to make very important decisions as to the desirability of permitting utility interests to maintain control of a variety of activities, such as transportation, water supply, and oil production. Of course, at this early stage, I cannot give you any indication of the extent to which the operation of this section may involve segregation of such businesses in independent hands.

Holding company systems must be simplified not only with respect to their geographical distribution but also as regards their corporate organization. Under paragraph (2) of subsection (b), the Commission is directed, also after January 1, 1938, to bring about the simplification of these structures so as to avoid unnecessary complications and unfair distribution of voting power. It is also specifically provided that this simplification must reduce all holding company structures to a point where there is not more than one layer of intervening companies between the top holding company and the operating companies.

Although the Commission is directed to initiate its action under subsection (b) as soon as possible after January 1, 1938, subsection (c) indicates that any orders issued pursuant to this mandate may grant a period of as long as a year for performance, and may even be extended for an additional year where necessary. Thus, it is possible that the process of simplifying holding company systems and corporate structures will not be completed much before 1940.

Subsection (d) provides that the Commission may enforce its orders by receivership proceedings, where necessary. It is, however, to be hoped and expected that companies will bring about voluntary reorganizations and readjustments so as to simplify their own structures before the Commission is compelled to act under Section 11. In order to facilitate such voluntary reorganizations, subsection (e) of Section 11 provides that, any time after the first of next year, any registered holding company or subsidiary company in a system may voluntarily submit to the Commission a plan of reorganization or readjustment, and ask the help of the Commission in putting this plan through. If the Commission approves of the plan and the company finds that it cannot be effected without court proceedings, the Commission may, if it consents, be appointed trustee by the court so as to insure an orderly distribution and readjustment of interests. Let me repeat that receivership proceedings under this provision are to be only at the voluntary request of the companies concerned.

Under subsection (f), the Commission is permitted to intervene in other reorganization proceedings in Federal courts in order to express its views as to the desirability of the plan involved. The court may, with the Commission's consent, make it trustee, and in any event it cannot approve any plan which has not met with the approval of the Commission.

In order to make sure that security holders of companies which are undergoing reorganizations, either under Section 11 or in the ordinary course of corporate evolution, may be fully aware of the nature of the reorganizations and of the consideration which must be given to the problems presented by regulation of the company under the Holding Company Act, Section 11(g) provides that no plan of reorganization may be submitted to security holders without having been first submitted to the Commission, and unless a copy of the Commission's report and comments on the plan or an approved summary thereof are likewise given to the security holders. This means that, although in many reorganizations, conducted in State courts or effected without judicial supervision, the Commission may not actively intervene, it will be given an opportunity to call to the attention of security holders what it deems to be the merits or demerits of the various plans involved. The Commission is also given a general power to regulate the manner in which the solicitation of assents to plans of reorganization shall be conducted, so as to protect investors against high pressure methods which may compel them to assent to a reorganization without an adequate understanding of its effect on their rights.

We come now to a number of provisions designed primarily to protect operating companies against the manifold methods of exploitation at the hands of the holding companies that control their common stock, which have come to be known collectively as "milking", and also to protect investors in holding companies and their subsidiaries against exploitation at the hands of insiders. One abuse is prohibited outright. That is the upstream loan. Section 12(a) makes it unlawful for any registered holding company to borrow from a subsidiary or from any operating company in the same system. Even representatives of the utilities agreed, at the hearings on the Bill, that this practice is difficult to justify and of no real necessity.

The remainder of Section 12 specifies various fields in which the Commission is authorized to prescribe rules and regulations which may be found appropriate to prevent abuses. The content of the regulations is left to the Commission and no prohibition is effective until the rules or regulations are adopted.

Section 12(b) extends this regulatory power to downstream loans, which, it was felt, often serve a legitimate purpose where an operating company cannot get adequate credit outside the system, but which, in some cases, appear to have been forced on subsidiaries at excessive rates of interest.

Under subsection (c), the Commission is authorized to regulate the payment of dividends by registered holding companies and their subsidiaries. One of the greatest injustices to which the investing public has been subjected, as a result of the use of the holding company device in the financing of the public utility business, has been the practice of some holding companies in compelling their subsidiaries to pay dividends when such payment obviously prejudiced the investment of the holders of bonds and preferred stocks of the subsidiaries.

You will recall that acquisitions of utility assets and securities require the approval of the Commission pursuant to Sections 9 and 10, under which the company acquiring the property must file application. In order that the Commission may, when necessary, scrutinize the transaction from the point of view of the disposing party as well, Section 12(d) extends the regulatory power of the Commission to transactions in which registered holding companies sell securities owned by them, of other public utility companies, or sell utility assets.

Some of you are doubtless familiar with the regulations regarding the solicitation of proxies which were recently prescribed by the Commission. These provide that when proxies are solicited with regard to securities which are listed on national securities exchanges, the person whose proxy is solicited must be given certain specific information regarding the matters on which his vote is to be cast, and must also be informed of the platform of any minority interests who duly submit their demands to the management and meet the expense of furnishing this additional information. These regulations were adopted pursuant to Section 14 of the Securities Exchange Act of 1934. Section 12(e) of the Holding Company Act gives the Commission similar power to prescribe regulations as to the solicitation of proxies regarding securities of registered holding companies and their subsidiaries.

Whether regulations under this Act will be the same as those under the Securities Exchange Act has not yet been determined, but the regulations now in effect under the Exchange Act give some indication of the type of regulation which might be found suitable.

In drafting any legislation which is designed to prevent the recurrence of a manifold series of abuses, it is practically impossible to prohibit in advance every abuse which may be perpetrated and to specify precisely what may and may not be done. If this were attempted by broad prohibition, there would inevitably be much hardship imposed in the case of unforeseen situations. On the other hand, if the scope of the statute were limited to obvious abuses spelled out in detail, it is almost certain that lawyers would find means of evading the Act by subtle variations of familiar practices. To prevent this, Section 12 (f) gives the Commission power to regulate all transactions between companies in the same holding company system, or between such companies and their affiliates, which may not be regulated under other sections of the Act. It is indicated that these regulations may cover such matters as accounts, costs, maintenance of competitive conditions, disclosure of interest, and duration of contracts. Section 12(g) gives the Commission a similar grant of authority with respect to transactions between public utility companies generally and their affiliates. You will note that most of the provisions of the Act are concerned only with companies that are members of holding company systems. This provision, however, will give the Commission power to prevent the perpetration of some abuses similar to those which have characterized holding company activities in cases where the more elaborate regulation providing for holding company systems might not be appropriate.

Activities on the part of holding companies and their subsidiaries with respect to the agencies of government are curbed by sub-sections (h) and (i) of Section 12. The former prohibits the making of contributions to political campaigns; and the latter provides that all compensation paid to lobbyists and other representatives and expenses incurred by them must be reported to the Commission. This applies not only to persons who attempt to influence legislation in Congress, but also those who represent holding companies and their subsidiaries before the Federal Power Commission or the Securities and Exchange Commission.

There is one other feature of the holding company system which is subjected to regulation in some detail. This is the general field of service, sales, and construction contracts. One of the greatest benefits which has followed from the development of holding companies has, perhaps, been the opportunity which the small operating unit is given for obtaining expert management, engineering, and similar services, normally available only to large concerns, and for purchasing equipment at wholesale rates. Most holding companies have, however, thought it reasonable to make the operating companies pay for these benefits through fees, either paid directly to the parent company, or paid to other subsidiaries owned directly by the parent company and passing the profits up to it by way of dividends. The temptation to overcharge has often been too great and the losers are the public who invest in the operating company's securities but have no control over the management that enters into these contracts, and in some degree the utility customers.

In order to preserve to the operating companies these advantages of large scale transactions, and to protect them from the disadvantages, the

mutual service company has been advocated by many critics of the system and adopted by some companies. The essential idea is that services are performed for a group of operating companies by a company which is collectively owned and controlled by them, instead of controlling them. The savings all inure to the benefit of the member companies, either by way of dividends proportionate to the services they have paid for or as a result of charging for services on a cost basis without profit to the service company.

Section 13 of the Act contains the provisions applicable to the problem we have been discussing. In the form in which it was originally passed by the Senate, this section (with the exception of cases involving particular circumstances) required the adoption of the mutual service company device as regards all service contracts between affiliated companies in holding company systems. In the final version of the Act the solution is left more to the discretion of the Commission, but the performance of service, sales, or construction contracts by holding companies is prohibited. The performance of such contracts by other subsidiaries for members of the system is subjected to regulations of the Commission, which shall, among other things, require performance at cost, fairly and equitably allocated, but the Commission may make exceptions where the circumstances are unusual. It is expressly directed in subsection (d) that the Commission shall prescribe terms and conditions for the approval by it of mutual service companies, and shall not approve them unless they are so organized as to insure service at a reasonable saving over the cost to such companies of comparable contracts performed by independent persons.

The Commission's jurisdiction as regards service, sales, and construction contracts is not confined to holding company systems. Section 13(e) provides that it shall extend, in completely discretionary form, to all public utility companies engaged in interstate commerce and to their affiliates, as well as to affiliates of holding companies and of their subsidiaries. The term "affiliate" is defined by Section 2(a)(11) to include any company which has a 5% voting stock ownership of, or is 5% owned by, another company. Officers and directors are also classed as affiliates, and the Commission is given the further power to determine a company to be an affiliate of another if it finds that, in fact, there is a relationship causing an absence of arms-length bargaining between the two.

In order to insure that the Commission has adequate control over the performance of service, sales, and construction contracts, it is given jurisdiction not only over public utility companies and their affiliates, but is also given authority by Section 13(f) to regulate the transactions of independent service, sales, or construction companies, engineering firms, etc., whose principal business is the furnishing of such services. This jurisdiction extends only to transactions with public utility companies subject to the Commission's control, and does not affect the conduct of the business of such persons with their other customers.

Finally, the last subsection, (g), directs the Commission to make a further study of the whole problem of service, sales, and construction contracts, and to make recommendations as to the best means of assuring adequate service and as to any further legislation which it may deem necessary.

Section 14 allows the Commission to require periodic and special reports from registered holding companies to provide it with the information which it needs in administering the Act.



One of the most important and one of the most difficult tasks given to the Commission is that of regulating the keeping of accounts by companies which are subject to its jurisdiction. This is covered by Section 15. You are, no doubt, familiar with many of the complexities that have resulted from the natural desire to make a favorable impression on the investor and at the same time not to appear too opulent to the rate payer and the tax collector. In most instances, it would obviously be desirable to have all companies keep their books in the same way. Not only would this save a great deal of time and money in rate and tax litigation, but it would give the investor an intelligent basis for judgment. Considerable progress towards uniformity has resulted from the Uniform Classifications of Accounts for Electric and Gas Utilities adopted by the National Association of Railroad and Utilities Commissioners. The adoption of any further standardization of accounting methods is a tremendously difficult problem and one which must be approached with great deliberation. At every stage, of course, there will have to be the fullest cooperation with State Commissions as well with the Federal Power Commission.

Officers and directors of registered holding companies are required by Section 17 to report to the Commission their transactions in the securities of such companies and their subsidiaries. This provision is similar to that which is now in operation under the Exchange Act with regard to companies whose securities are listed on national securities exchanges, except in two particulars. The Holding Company provision is broader in that it requires reports as to the ownership of all securities, including those of subsidiaries, whereas the Exchange Act refers merely to equity securities of the issuer. On the other hand, the Holding Company provision is applicable only to officers and directors of registered holding companies and not to 10% stockholders as in the case of the Exchange Act. Subsection (b) of Section 17, like the corresponding provision in the Exchange Act, compels these officers and directors to give up to the company any profits which they may make from short term speculations over a period of less than six months.

Interlocking control between public utility holding company systems and banking and stock brokerage interests has undoubtedly been one of the causes of the questionable financial methods which have been pursued in raising capital for the public utility industry. Section 17(c) is designed to eliminate this source of abuse by providing that registered holding companies and their subsidiaries cannot have as officers or directors representatives of financial interests. You will notice that this provision does not become effective until a year after the enactment of the Act, in other words, August 26, 1936. Moreover, the Commission is given power, by rules and regulations, to grant exemptions in cases where continuation of the interlocking control does not adversely affect the public interest or the interest of investors or consumers. Title II contains a similar provision with reference to companies that come under the jurisdiction of the Federal Power Commission, which, however, becomes effective six months after the enactment of the Act and calls for applications for exemption to be made to that Commission on or before October 25, 1935.

The remaining provisions of the Act are concerned primarily with administrative and procedural details, which I do not propose to discuss at length. I might, however, call your attention to Section 22, regarding

the public character of information filed with the Commission. The Commission is given complete discretion to make public such information or to keep it confidential, as it deems that the public interest or the interest of investors or consumers may require. Of course, in most instances, it is highly desirable that the activities and affairs of our public utility companies be open to inspection by all. On the other hand, cases sometimes arise where an administrative body feels that it needs information as a basis for action by it, the disclosure of which to the public might give rise to an entirely false impression, or prejudice the legitimate business interests of the company.

In conclusion, I should point out one new duty assigned to the Commission which does not concern public utility systems, as such. Section 30, among other things, directs the Commission to make a study of a different area of corporate finance, in which the public lost great sums of money following the collapse of security values. This is the whole field of investment trusts. The Commission is directed to make a study of the problems involved and to report to Congress its opinion as to what form of Federal legislation, if any, should be passed. The study that must be made under this mandate is not yet under way and I cannot, of course, attempt to predict what sort of recommendations will be made.