CHAPTER XV

CONSERVATIVE FINANCE AND THE HOLDING COMPANY ACT

This talk was given before the Harvard Club of Boston in November, 1938, eight months after the Supreme Court had upheld the constitutionality of the registration provisions of the Holding Company Act. By this time virtually all the holding companies had registered with the Commission, after having resisted the law since its enactment in 1935. Thus there had been a delay of nearly two-and-a-half years before the Commission and the industry could begin to tackle the many technical problems of administration.

During the heat of battle over the Public Utility Holding Company Act of 1935 the picture was frequently drawn of its destructive qualities. But since then there has been greater and greater recognition that that Act calls only for conservative practices—for practices and standards designed to protect the industry itself and the investors and consumers against financial wizardry, indiscretion, and excesses. This has come about as a result of the fact that emotionalism has been on the wane and business judgment and technical considerations have been on the ascendancy. A few examples will illustrate what I mean.

We need not have elaborate statistical or financial studies to know that write-ups of property accounts or of investments have been the sand upon which some holding-company structures have been built. We know that in times of stress and strain some of those structures have collapsed or have become dangerously top-heavy as a result of such practices. Under the Act the matter of write-ups is hereafter the concern of the Securities and Exchange Commission. It arises in several ways. Thus on the issuance of securities by registered holding companies or their subsidiaries the Commission must be satisfied that the security is reasonably adapted to the earning power of the issuer. It is also its duty to prevent the payment of dividends out of capital, to prevent the payment of dividends which will impair the financial integrity of companies in the holding-company system. As a result of these and other provisions of the Act the detection of write-ups is a continuous necessity; the elimination of write-ups is frequently essential. The work which the Commission and the industry have done on this problem has led to extremely significant results. The elimination of write-ups by voluntary act of the industry has become truly fashionable. Published results to date tell only a fraction of the story. In many utility offices today elaborate plans are under way to restate these accounts along conservative lines. This will entail the elimination of many millions of dollars of water from utility structures. Many of these efforts will bear fruit soon; others will take longer, since in some cases delicate operations are necessary. But greater progress is being made. And one utility executive recently told me: "Give me time, and the

elimination of write-ups is not only theoretically sound, it is desirable as a cold practical proposition." And another company official called us up on the telephone and said: "We want to eliminate some write-ups in our system. Will you show us how to do it under the Act?" So when the elimination of write-ups becomes, as it has, the "fashionable thing to do," we can rest assured that the practical men in the industry have found in the letter and spirit of the Act provisions which appeal to the judgment and instincts of conservative financial men.

Another example of conservative practices instilled through the Act relates to the creation of debt by holding companies. Under the Act holding companies can issue bonds only under exceptional circumstances. The purpose of the restrictions is clear. They were partially designed to eliminate unsecured bonds which had behind them only a portfolio of common stock or other securities and hence by conservative standards did not warrant the normal connotation of that term. Furthermore, they were designed to protect the holding company itself from unsound capital structures; they had as their purpose creation of capital structures of holding companies composed essentially of stock, preferably common stock, so that the ups and downs of cyclical trends could be more readily weathered. The other day a prominent holding-company executive was in my office. He had caused his holding company many years back to issue debentures. He was relating to me the headaches which those debentures had caused him. In times of great prosperity, he said, the enormous leverage in the stock which was in the holding-company portfolio made those debentures seem as strong as Gibraltar. But when markets declined and earnings fell, those debentures with their promise to pay and with their heavy interest requirements became the bane of his existence. Only by Herculean efforts could he save his entire holding-company structure from complete collapse. On the basis of that experience he vehemently pounded my desk, saying, "Never let any holding company issue any debt." Here was an executive of broad experience adopting on the basis of his own experience a conservative standard of finance—a conservative standard which the Congress wrote into the Act in modified form in 1935.

That Act is replete with similar examples. Thus there is the provision which makes it possible for a holding company to have children and grandchildren but not relatives of a more distant relationship. Men of the world of finance approve that general standard. They approve (at least all to whom I have talked do) because they know on the basis of experience that once a top-heavy holding-company structure is created, with tier upon tier of companies, it takes not only a higher mathematician but a magician as well to figure out what the third preferred stock (not to mention the fourth preferred or the common) in the top company really is worth. The technical men and the policy men in the industry silently

approve in practice as well as in theory such examples of conservative financial practices.

And aside from the normal conservative practice which the Act instills there are other provisions which reduce the risks of extravagant practices in which the occasional financial genius has reveled. Two of these are noteworthy of comment. One was presented to me impressively by an operating company only a few weeks ago. This operating company had had a good record. It operated exclusively in one state. It was proud of its intrastate character. Its securities were largely held locally. Years ago it suddenly awoke to the fact that a far-distant and foreign holding company was silently acquiring its stock for purposes of control. The management was startled at the prospect and saw happening to them, if the foreign raider was successful, what had happened to other local companies; namely, a siphoning off of their assets to some distant financial center. Working feverishly, it and its lawyers worked out an elaborate scheme to prevent such control from being acquired. Without going into details, suffice it to say that they created a holding company of their own with an elaborate voting trust as well, and sought deposit of the outstanding securities. With that legal paraphernalia, too elaborate to discuss here in detail, the contest was on. The local company moved with sufficient dispatch substantially to thwart the plans of the foreign holding-company raider. But the complicated holding-company structure which was created to accomplish the result remained, piled on top of this operating company and making cumbersome its every act. In fact, that top structure was viewed by the company itself as somewhat of a monstrosity. To those who are proud of their local companies, who desire to keep them local, who desire to prevent them from becoming overnight a mere pocket in a foreign holding-company system, the Act is a great comfort. For the Act places great restrictions on such acquisitions. They can be made only after public hearing before us with opportunity for interested parties to be heard and then only on our approval.

From the viewpoint of those who desire to keep their utility industry at home, or in many cases to bring it back home, the Act holds great promise of comfort in other respects. As you know, the Act contains standards for geographical integration of holding-company systems. As a general rule—-there are exceptions—it provides that a holding company must confine itself to a single, geographically integrated system. The Congress discarded the "scatteration" theory which would permit far-flung scattered properties to be pulled together into one huge utility empire. The Congress decided in favor of integrated local or regional systems, closely knit, compact, and confined geographically. I personally think Congress decided wisely. But whatever may be any one person's view as to the soundness of that decision, that mandate is the law of the land. And it is gaining enormous practical appeal to numerous local or regional interests or groups. Local leaders, including investment bankers, are fast awakening to the realization that here is a superb

opportunity to free their home or regional enterprises from remote control. Responsible citizens from a number of states have conferred in my office during the last few months on their paper plans to reconstruct various utility properties along state or regional lines. Many who have been seriously intent on bringing control of home industry closer to home now see a way of doing it. How these tentative plans will work out is too early to predict. Certainly, we are going to give a right of way to the plans, desires, and programs of the industry, so far as is reasonably consistent with the standards of the Act. I merely emphasize at this point the opportunity, now being realized for the first time, for those who desire to keep their basic industries at home.

And I might add, parenthetically, that the realization on the part of investment bankers of the enormous underwriting and distribution job involved in all these programs is beginning to provide something of a profit-motive spark plug in the whole process. At least wherever that realization has appeared, the wheels have begun to turn.

These matters are, as I have said, illustrative of the conservative business and financial standards which pervade this statute. They point up and illustrate one of the real reasons why a genuine business and financial leadership is not guilty of supine submission to "crack-pot" theory, but rather displays the conservative stewardship of old-fashioned standards when it puts its shoulder to the wheel with us to make these statutes going concerns.

So much for the will on the part of business and finance to assume a position of leadership. Now as to *modus operandi*. Perhaps, after the comments which follow, I should make a slight apology to my lawyer friends. For my formula on *modus operandi* is to leave the lawyers out of it. At one of our hearings a few years ago the late Grayson M. P. Murphy with his usual sparkling humor commented from the witness stand that the surest way of producing a real case of the jitters was to give a New York lawyer a few minutes to confer with a New York banker. However that may be, I can state the following indisputable facts of record. In the first place the progressive program worked out between the New York Stock Exchange and the S.E.C. and now in process of being consummated was done without benefit of counsel. In the second place, the rapid strides being made by the utility industry to work constructively with the S.E.C. in developing a holding-company act program was likewise accomplished without any intermediary in the form of lawyer or otherwise. That is fact number one. Fact number two is this. Once the lawyers disappeared from the holding-company scene and the executives of those companies sat down for direct conversation with me and my colleagues, peace and harmony began gently to settle over the entire scene. That in turn may be nothing but a coincidence. But to those who are thinking in terms of *modus operandi*, I do not think it is entirely irrelevant.

There is no magic formula for bringing together conflicting interests and enabling them to sit down together around the table and resolve their differences. Those who seek such a formula bring to mind the portrait of the ancient Chinese physician of the fifth century B.C., who was the great healer of his day. The portrait shows him girt with ropes of herbs and minerals which he had collected from various parts of the earth for their medicinal qualities. But they had failed him. And deep in thought he walks beside a placid lake upon whose unruffled surface the moon's reflection rests. He reaches out his hands toward the mirrored image and exclaims, "Ah, if only I could gather up the healing properties in the moon as well, I would cure all of man's ills."

As ephemeral as the reflection of the moon on the water are the qualities which will fuse the energies of Government and business. Yet, wherever the search for those qualities may lead, I am convinced that their discovery will be a positive force for democracy and capitalism. For by their discovery, we will have placed deep in the national consciousness a philosophy whose curative qualities may have almost mystic effects. That is why this new enlightened business leadership, accepting the philosophy of the new legislative program, holds such great promise.