REMARKS OF

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Introduction

It is a pleasure to appear here today and to discuss with you some of the activities of the Securities and Exchange Commission. I would like initially to outline in the broadest and most general terms the functions and responsibilities of the Commission.

The federal securities laws were enacted principally to restore investor confidence in the public securities markets and to provide a comprehensive regulatory scheme to further the protection of investors and the public interest. The successful implementation of these statutes has produced the fairest and most orderly securities markets in the world and has enabled individuals and institutions to invest in these markets with confidence in their basic integrity.

The federal securities laws established two primary methods of regulation. The first consists of the requirement of full disclosure for substantially all publicly held companies or companies going public of material facts concerning their management, business activities and financial history and condition. Disclosure is required not only at the time a company desires to sell its securities to the public, but also periodically through reports showing the results of the company's operations. Disclosure of financial and other information provides a basis on which investors may make a realistic appraisal of the merits of a security and thus exercise an informed judgment in determining whether to purchase or sell it. An essential second element in the disclosure process is the antifraud provisions of the securities laws. In essence, these provisions make unlawful the use of any manipulative, deceptive or fraudulent device or contrivance in connection with the purchase or sale of any security and outlaw the making of materially false statements or the omission of material facts. Violation of these provisions gives rise to both civil and criminal penalties.

Many have assumed that the securities acts, and more particularly the scheme of disclosure which has worked so well, was the product of the New Deal era of the Thirties, and that they result from the climate which existed at that time. This is not entirely correct, however, since the drafters of the securities acts followed closely the experience of the English in providing for the protection of the public investor. In 1720, for instance, there was wide-spread speculation in England of which the shares of the South Sea Company are symbolic. This particular company, which had as its Governor King George I, was organized to trade with South America and the Pacific Islands. The shares of the South Sea Company in a surge of activity rose from £ 128 in January of 1720 to over £ 1,000 in July and back to £ 125 in December. I should mention that the directors of the company sold £ 5 million of the stock at the ceiling. After the Great South Sea Bubble had burst with its resultant ruin of thousands of investors, Parliament passed the so-called "Bubble Act" of 1720. The provisions of that statute were so severe that, had they been followed, virtually all stock trading would have ended. Largely for this reason the Act was somewhat of a dead-letter until its repeal in 1825. Meanwhile, companies continued to grow. In 1844 a committee, Chairmanned by Gladstone, made a historic report to Parliament. That report observed, "periodical accounts, if honestly made and fairly audited, cannot fail to excite attention to the real state of a company and by means of improved remedies parties to mismanagement may be more amenable for acts of fraud and illegality." The "Companies Act of 1844" adopted the recommendation of the Gladstone Committee and provided for the first time compulsory disclosure for public investors in a prospectus.

One of the drafters of our 1933 Act referred to this English legislative history at length in a 1933 magazine article. The thoughts he expressed in 1933 parallel closely the report made to Parliament in 1844. They were:

> "Fair play at the start is most essential. The prospectus is the basic appeal to the investor's pocketbook. The rationale of the Securities Act is insistence on candor and completeness in making this appeal. It may be ingenious to deem truth an automatic protection against greed and credulity in investors. Much more could be done in governmental oversight of the mechanism of capital investment. But to compel the light now demanded by the Securities Act in places often consciously darkened is merely to require the elementary basis for knowledge before asking people to invest (their) savings..."

It must be conceded that disclosure since 1933 has done much to reassure the investor and assist in maintaining healthy securities markets.

The second major aspect of the regulatory scheme has been designed to insure that once an investment decision has been made it is properly carried out through the facilities of an organized securities market which must necessarily rely, in large part, upon the professional broker-dealer community. This facet of regulation establishes certain fundamental requirements for anyone engaging in the broker-dealer business. These requirements help to insure that when a public investor does business with a registered broker-dealer, he can do so with confidence in the firm's basic integrity.

There is another interesting feature of the Commission's regulatory responsibilities and that relates to the securities markets and over-the-counter markets. Under the federal statutes, the stock exchanges are made responsible in the first instance for the regulation of their members' conduct and for their compliance with the federal securities laws. In the over-the-counter markets, the National Association of Securities Dealers, established pursuant to an Act of Congress in 1938, is primarily responsible for the regulation of its members. The Commission is charged under the statutes with the responsibility of overseeing the activities of the various stock exchanges and the NASD and has authority to review, alter and amend the rules of these self-regulatory groups. The net effect of this regulatory pattern is to combine the best efforts of the industry with the Commission in a comprehensive regulatory program the objectives of which are the prevention of fraud and manipulation, and the encouragement and maintenance of equitable business practices and of fair and orderly markets in securities.

Of a somewhat different nature are the statutes the Commission administers which regulate the activities of publicly held companies which are primarily engaged in the business of investing or trading in securities. In this area the Congress gave the Commission more regulatory responsibilities in recognition of the highly liquid form of capital available to these companies. As a consequence, the Investment Company

Act of 1940 provides a comprehensive framework of regulation which, among other things, requires management contracts to be submitted to shareholders for approval and provides for Commission scrutiny of transactions between investment companies and their affiliates.

Recent Developments

The task of discharging our responsibilities under these various statutes is more difficult today than any time since the early Thirties. This is due largely to the tremendous growth experienced in all phases of our securities markets during the past decade. Many of the problems confronting the securities industry and the Commission stem from the difficult adjustments which have had to be made. In 1959, there were about 12½ million individual shareholders, including owners of mutual fund shares. By 1965, this figure had reached 20 million, and at the start of 1970 there were 31 million shareowners. Another 100 million have participated indirectly through their savings, insurance policies and in pension funds. Trading volume exceeded every expectation. While the volume of shares traded on all registered stock exchanges has declined in the first six months of this year, about 18 percent from its 1968 first half highs, it rose 160 percent between 1964 and 1968. That was at a rate of 27 percent each year. In the over-the-counter market the increase also was fantastic. As the overall volume increased, the mix of this volume significantly changed. While the block volume (trades of 10,000 shares or more) on the New York Stock Exchange has risen from less than three percent of total volume in 1964 to 14 percent today, the number of transactions in the last two years on that exchange has dropped by 28 percent; and in the same two-year period, the one-hundred-share round-lot transactions are down 36 percent and the odd-lot volume is down 37 percent, while transactions of 10,000 shares and over have more than doubled. Hedge funds -- both private investment partnerships and registered open-end investment companies authorized to engage in speculative-type trading activities -- assumed an increasingly larger role in the stock market in 1968 and 1969. The $8 billion aggregate trading activities of these hedge funds -- long and short combined -- was nearly as large as the combined trading activities of insurance companies, both life and property and liability companies in 1968. In 1969, the trading activities of hedge funds substantially exceeded the trading activities of insurance companies. Hedge funds accounted for 4.6 percent of the shares traded on the New York Stock Exchange during the first half of 1969 compared with 4.2 percent for the insurance industry. Moreover, the trading activities of these funds were even more important in other markets -- accounting for 12.4 percent of the share volume in these markets compared with 3.2 percent of volume contributed by the insurance industry.

One of the most noticeable trends and one which is currently the subject of major study in the Commission is the increased trading activity of the major financial institutions. It is estimated that, at present, institutions, as a group, account for over 60 percent of the dollar value of public trading on the New York Stock Exchange. The size of the institutional order has risen substantially and today over 70 percent of them are for more than 1,000 shares. This explains, in part, why the number of trades has declined so much more than has share volume over the last two years. Portfolio turnover of the institutions continued to increase until the first quarter of this year. Leading this increased activity were the mutual funds, whose turnover rate increased from 19 percent in 1964 to 50 percent last year, and is at a current rate of 39 percent. The major institutions as a group have been heavy net buyers of stocks in recent years and in fact their net acquisitions have been larger each year since 1963 with a record $9.6 billion total added in 1969. This was more than 20 percent greater than in 1968. While net stock acquisitions of the institutions thus far this year are still greater than in the comparable period of 1968, they lag somewhat behind the record total of last year. Nevertheless, if the transactions of mutual funds, which tend to follow the market trend, were excluded from both periods, the net acquisitions of the other major institutions would have set a new record high in the first six months of this year.

Neither the securities industry nor, to my knowledge, anyone else anticipated these dramatic market developments. I believe it was late in 1964 that the New York Stock Exchange predicted that by 1980 NYSE volume would reach 8 to 10 million shares a day. Of course, trading volume in this range and well above soon became routine. The industry was not yet geared to handle any such surge in activity and the back office snarl for which it was to pay so dearly soon appeared. I might also mention there seems to have been a close correlation between back office problems and an individual firm's ability to survive.

The changes in the securities markets also had their impact on the Commission's workload and this was so even in periods when security prices were declining. Even in today's markets I can assure you that we still have more business than we can handle. During the fiscal year of my appointment to the Commission, 1964, there were a total of 1,192 registration statements filed under the Securities Act. I watched this number progressively increase to 1,376 in 1965; 1,697 in 1966; 1,836 in 1967; 2,906 in 1968, until it reached a record high of 4,706 in 1969. During the last fiscal year, a total of 4,314 registration statements were filed. Only in recent weeks has there been a decline and if the market follows through on what appears to be a bullish trend I assume the filings will again set new records.

The Division of Corporate Regulation, which is responsible for the review of filings made by investment companies registered under the Investment Company Act of 1940, has also been faced with an increased workload. At June 30, 1964, there were 731 investment companies registered with the Commission. As of August 31, 1970, this number had risen to 1,329, an increase of approximately 82 percent since 1964.

The Holding Company Act

I would like to turn now to an aspect of the Commission's work which may be of particular interest to your group since it may affect some of your activities -- that being the Commission's administration of the Public Utility Holding Company Act.

In 1935 the Congress adopted the Public Utility Holding Company Act and entrusted the Commission with its administration. The Holding Company Act was passed to curb myriad abuses which were disclosed in lengthy Congressional hearings on the operations and structure of public-utility holding company systems. At the time the Act was passed holding company systems controlled 80 percent of all electric energy generation, 98.5 percent of all transmission of electric energy across state lines, and 80 percent of all natural gas pipeline mileage in the United States. Many of the huge utility empires which existed in 1935 controlled numerous subsidiary companies operating in widely-separated states and having no economic or functional relationship to each other. Holding companies were pyramided layer upon layer, many of them serving no useful or economic purpose; and many systems had very complicated corporate or capital structures, with control often lodged in junior securities having little or no equity. A classic example of a system fraught with these conditions was that of Electric Bond & Share Co., in which there were over 200 subsidiaries in five different corporate tiers. Electric Bond & Share had seven direct subsidiaries of which four were themselves registered holding companies, with 39 separate utility subsidiaries in 25 states, and one other holding company which had 110 foreign subsidiaries. Each of the subordinate holding companies had debentures, bonds, several types of preferred stock and common stock outstanding, the income for which consisted of common stock dividends from and high-interest bearing notes of their utility subsidiaries. Within the entire system there were literally scores of different types of securities sold to the public, with write-ups of the assets of the underlying utility subsidiaries being as high as 300 percent.

Other systems such as Cities Service Co. and Associated Gas & Electric Company were similarly overlaid with securities and unnecessary intermediate corporations. And because of the interstate character of the various systems, state regulation was largely ineffective.

Under the Holding Company Act, interstate holding companies whose subsidiary companies operate an electric utility or distribute natural or manufactured gas are required to register; once registered, many of their major transactions, including their financing activities and acquisitions and dispositions of securities and properties, are subject to Commission scrutiny under the standards in that Act and they become subject to the Act's provisions for physical integration and corporate simplification. From the standpoint of their impact on the electric and gas utility industries, these latter provisions are perhaps the most important. Essentially, the physical integration standards of the statute restrict a holding company's operations to a "single integrated public-utility system,"--either electric or gas but not both--that is, one which is capable of economic operation as a single coordinated system and confined to a single area or region. Additional utility systems or incidental businesses are retainable only under very limited conditions, as I shall discuss later. The corporate simplification provisions of the Act require that the capital structure and the continued existence of any company in a holding-company system do not unduly or unnecessarily complicate the corporate structure of the system or unfarily or inequitably distribute voting power.

Compliance with these two statutory standards may be accomplished either by Commission initiative or by the company filing a voluntary plan which must be found by the Commission to be fair and equitable to all affected persons and to be necessary to further the objectives of the Act. All interested persons, including state commissions and other governmental agencies, are accorded opportunity to be heard in these types of proceedings.

The integration requirement, characterized by the Supreme Court as the "very heart" of the Act, implements the legislative findings embodied in the preamble which enumerate five separate evils, each of which does or may adversely affect the national public interest, the interest of investors and the interest of consumers. One evil is stated to exist where "the growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties."

As a result of the Commission's vigorous pursuit of the Congressional integration and simplification mandate, there has been a tremendous decline in the number of registered companies and of subsidiary companies in the registered systems. At one time or another during the past thirty-five years, more than 2,500 companies have been subject to the Act, including over 230 holding companies, 1,050 electric or gas utility companies, and 1,200 other companies engaged in a wide variety of businesses, among which were brick works, laundries, experimental orchards, motion picture theaters and even a baseball club and a college. Today the picture is significantly different. Only 17 active holding company systems are now registered, encompassing approximately 170 companies with aggregate assets of approximately $20 billion. Most electric and gas utility companies which formerly were associated with registered holding companies now operate as independent concerns. For example, all the electric companies now operating in Florida were, at one time, encompassed in various holding company systems; today, there is only one, Gulf Power Company.

The Congress not only directed the dismemberment of the complicated, overburdened utility holding company systems, but it also provided a means to prevent a recurrence of the abuses of the 30's by providing strict standards in the Act for the acquisition of securities, utility assets or interests in other businesses. To that end the statute gives the Commission regulatory authority over acquisitions so that what the Commission has put asunder shall not again be joined together. Among the standards in the statute which must be met is that such acquisitions must tend toward the economic and efficient development of an integrated public utility system and not be detrimental to the carrying out of the physical integration and simplication provisions.

While the first 25 years of the Commission's administration of the Act focused on, and as noted saw significant achievement in, the breaking-up of holding companies which did not conform to those provisions, the last decade has witnessed a dramatic about-face, so that, today, the Commission is called upon to decide, in ever increasing numbers, applications for acquisitions of new companies or properties, sometimes even resulting in the creation of new holding-company systems. The trend toward diversification is certainly not unique to the utility industry but it raises serious questions under the regulatory standards of the Holding Company Act.

An example of an acquisition which resulted in a new holding company is Pennzoil Company's acquisition of a substantial block of common stock of United Gas Corporation through a solicitation for tenders in the fall of 1965. Pennzoil and its subsidiaries, as I'm sure you know, owned and operated oil gathering and pipeline systems, refineries and marketing facilities for its lubricants, which were in no way connected with the utility business. United Gas Corporation, on the other hand, had a large retail gas distribution system, in addition to owning a gas pipeline company, an oil producing company, and a 70 percent interest in a copper and potash company. Pennzoil succeeded in obtaining 42 percent of the United Gas stock and thereby became a holding company required to register with the Commission as such. The existence of a retail gas utility business in a system which included numerous, unrelated non-utility operations raised serious problems under the integration standards of the Act. What Pennzoil ultimately proposed was to consolidate Pennzoil and United Gas into one company, Pennzoil United, and thus cease to be a holding company. The Commission concluded, however, that even if the holding company relationship were eliminated, the requirements of integration must be met. Consequently, we ordered that the consolidated company dispose of all its interest in the retail gas utility business.

The problem of the integrated holding company in a somewhat different context was before the Commission in January of this year. It involved Illinois Power Company, an exempt holding company, which applied for approval to acquire the common stock of another exempt holding company. Both companies are engaged in the electric and gas utility business within the State of Illinois. The Commission approved the proposed acquisition but on condition that the gas properties of both companies be divested. In its decision the Commission noted that electric and gas are essentially competitive, that they do not together constitute an integrated system and that it is highly unrealistic to expect vital competition between the two types of service when under common control.

The trend toward diversification of business has also presented the Commission with particular problems in its ramifications in the holding company area. The rationale for diversification appears to be the expectation that because investments in various industries earn at different rates and are subject to different market pressures, greater security may be achieved by spreading the risk of investment over broader areas. Under normal circumstances, this would appear to be simply a matter of business judgement.

However, Congress has determined that when a utility holding company is involved, diversification, with its managerial concentration on more profitable operations, may not be desirable. Consequently, the Holding Company Act permits retention by a registered holding company of non-utility businesses only where they are reasonably incidental or economically necessary or appropriate to the operations of the principal integrated utility system. An example of an incidental, related business is the ownership of a gas pipeline company -- which is not a gas utility as defined in the Act -- by a holding company system whose other subsidiaries distribute natural gas at retail, as in the case of the American Natural Gas system. Other examples might include a small steam heating service as a by-product of electric generation, or coal mining operations where the coal is used primarily for fueling the boiler of an electric generator.

When a public utility indulges in outside ventures, unrelated to the utility business, the investment caliber of its securities may decline, its costs of capital rise, and the rates which support the securities frequently become higher than might otherwise be necessary. The customers' interests also suffer if the management must divide its attention between the utility business and unrelated speculative ventures. Whether a holding company or its utility subsidiary engages in such enterprises the same result obtains. Historically, I might add, those holding company systems whose interests were the most diversified experienced the greatest difficulty in meeting interest payments on their various debt securities and were often the ones which defaulted on their preferred dividends and ultimately caused huge losses to their investors.

In connection with the adoption of the Act, Senator Wheeler, the manager of the bill in the Senate, observed with respect to the standards embodied in the bill, that utility holding companies should confine themselves to gas or electric services and not continue to mix into all manner of other business. The Commission has held, and four separate Courts of Appeals have agreed, that the retention of a nonutility business in a utility system may be allowed only on an affirmative showing of an operating and functional relationship between the operations of the public utility system and the non-utility business.

Recently, the Commission had occasion to consider again problems relating to the integration requirements in the Act in the case of Michigan Consolidated Gas Company, a gas utility subsidiary company. Michigan Consolidated Gas had previously organized Homes Corporation to construct and operate under the National Housing Act low and moderate income housing projects. It now proposed to acquire from the Homes Corporation $500,000 of additional common stock and up to $6,000,000 of its short-term promissory notes to provide necessary construction funds for two such projects. Upon completion of construction, the outstanding notes were to be retired with the proceeds from a 40-year mortgage loan covering about 90 percent of the cost of the project. The officers and employees of the gas company were to serve, to the extent necessary, in similiar capacities for the Homes Corporation.

In short, a gas-utility company, a subsidiary of a registered holding company, was proposing to acquire securities or an interest in a nonutility business. Such an acquisition requires Commission approval under the integration standards previously mentioned. A majority of the Commission decided in the Michigan Consolidated case that the ownership and management of a housing corporation did not meet the standards of the Act requiring an operational or functional relationship to the operations of a utility system or the exemptive test in the Act for acquisitions which might be found to be "appropriate in the ordinary course of business." The Commission observed that the business of the Homes Corporation was related to the operations of the holding company system only in that it might help to rehabilitate and preserve areas served by Michigan Consolidated Gas. A customer relationship between a nonutility and a public-utility company was held by the Commission, as it had previously held on numerous occasions, not to be the type of operating or functional relationship which Congress contemplated in the Act. It seems apparent that such a relationship could be established with respect to almost any business, and if permitted to constitute a basis for retainability or acquisition of non-utility interests or businesses under the standards of the Act it would enable a utility system to engage in almost any sort of activity contrary to the intent of the Act. The companies have filed a petition for review of the Commission's Michigan Consolidated decision in the U.S. Court of Appeals for the District of Columbia Circuit. Subsequent to the Commission's decision a bill, prepared by the Department of Housing and Urban Development and reflecting the Commission's suggestions, was introduced in the Senate to amend the Holding Company Act to permit limited investment, upon such terms and conditions as the Commission may permit by rules and regulations or order as not detrimental to the public interest, by subject utility companies in low and moderate income housing projects under the National Housing Acts. The Commission advised the interested Senate Committee that it would have no objection if the Congress were to enact the proposed amendment. In Michigan Consolidated what a majority of the Commission decided was that the statute was unambiguous and that acquisitions of the type proposed were not permissible. The proposed legislation would change this as indicated, and permit certain limited investments.

As you are undoubtedly aware, a number of large companies such as Tenneco, El Paso and Northern Natural have expanded their interests beyond that of transporting natural gas. Of course, the Commission has no regulatory authority over such companies. Pipeline companies, as I mentioned earlier, unless they are part of a public-utility holding company system are not regulated by the SEC under the Holding Company Act. In fact, there has been, noncoincidentally, no attempt by the large pipeline or producing companies to acquire their customers, the gas distribution companies, which acquisitions would make them holding companies and therefore subject to regulation under the Holding Company Act.

There are some holding companies, which are exempt from the Holding Company Act, which have ventured into other investment fields, and over such companies the Commission has some regulatory jurisdication. Generally, aside from some automatic exemptions provided in the rules of the Commission, a holding company may obtain an exemption under the exemptive provisions of the Act only pursuant to an order for which application must be made. The statute provides that the Commission grant such application unless and except to the extent that the exemption would be detrimental to the public interest and the interest of investors and consumers. In addition, even when an exemption is granted, the Commission is authorized by the Act to revoke the exemption in the light of changed circumstances. I am confident that exempt holding companies which have embarked upon diversification are fully aware of the Commission's authority in this area.

What I have outlined for you is the extent to which the Commission may deal and has been dealing with the ever-growing pattern of diversification, where it relates to the holding company segment of the public-utility industry. I want to emphasize the Commission's concern over the growing number of utility companies embarking on ventures unrelated to their utility operations. Today, as in the 1920's and 1930's, the need of a public-service industry to concentrate on that service is critical. The Congress was rather specific in its direction to the Commission to enforce the requirements of the Holding Company Act and in the preamble enumerated the major concerns which gave rise to its passage. I can assure you that the Commission shall continue to administer the Act giving full weight to these Congressional concerns.

I wish to thank you for your time and trust you have gained some understanding of the functions of the SEC and of some recent developments relating to the Holding Company Act.