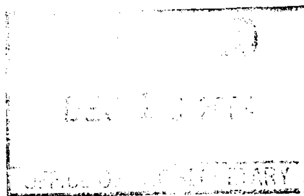

Public Citizen Exhibit 2

PREPARED DIRECT TESTIMONY

LYNN N. HARGIS

SEC ADMIN PROCEEDING

FILE NO. 3-11616

I. INTRODUCTION AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND CURRENT POSITION.

A. My name is Lynn N. Hargis. My business address is 215 Pennsylvania Ave. S.E., Washington, D.C. 20003. I am a volunteer attorney/lobbyist for Public Citizen, Inc.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND.

I received my B.A. in English literature from Southern Methodist University in Dallas, Texas in 1964. From 1964 to 1966, I worked on the Washington, D.C. staff of the senior U.S. Senator from Texas, Ralph W. Yarborough. I subsequently taught English as a foreign language in Madrid, Spain, and worked at other jobs unrelated to my professional qualifications.

I received my J.D. from the University of California at Berkeley School of Law (Boalt Hall) in 1975. During the summer before my last year (1974), I worked in the legal office of El Paso Natural Gas Company in El Paso, Texas. Following law school, I worked as a trial lawyer on the electric and gas trial staff at the Federal Power

Commission, then the Federal Energy Regulatory Commission, from 1975 to 1978, and in FERC's appellate division from 1978 to 1979. I served as Assistant General Counsel for Electric Rates and Corporate Regulation from 1979 to 1985, with advisory responsibility to the FERC on all matters arising under the Federal Power Act, PURPA and any other electric rate matters.

I served as Counsel in the Washington, D.C. office of Chadbourne & Parke, LLP, a New York-based, international law firm, from 1986 through May, 2003, in the energy division, and subsequently in the project finance division. Our clients were primarily developers of or lenders to independent power plants around the world. I gave them advice on FERC, PURPA and PUHCA regulatory matters, and occasionally, on questions of state regulatory law. I have spoken and written numerous articles on the FPA, PURPA and PUHCA, given a seminar at the World Bank on American regulation, and for many years given updates on PUHCA and PURPA at my law firm's annual client meetings. My most recent speech was at the annual meeting of the National Association of State Consumer Advocates in Nashville, Tennessee, on November 12, 2004. I spoke regarding a pending law suit in the U. S. Court of Appeals for the D.C. Circuit challenging FERC's authority under the Federal Power Act to allow markets to set wholesale electric rates.

Q. ARE YOU BEING PAID FOR THIS TESTIMONY?

A. No, I am not.

Q. THEN WHY ARE YOU GIVING TESTIMONY?

A. In my thirty-odd years of electric utility regulatory practice, I have come to believe that the Public Utility Holding Company Act of 1935 ("PUHCA") is the most important piece of federal legislation relating to electric and natural gas utilities. I

believe that if PUHCA is repealed, either by the Congress or administratively by this Commission, the consequences to electric and natural gas utility consumers and to our national economy may be catastrophic. I believe it is my responsibility as a citizen to share some of the knowledge I have gained over the past thirty years, since most of the people with comparable knowledge are being paid by the utility and other industries. Also, from a selfish point of view, a lot of my retirement money is in the stock market.

Q. WHAT "OTHER INDUSTRIES" WOULD HIRE PUHCA EXPERTS?

A. PUHCA does not allow non-utilities to own and control utilities. In order for an oil company to control utility stock, for example, the oil company would have to divest its oil businesses. Clearly, that will not happen. There are many other industries—oil, insurance, banking, equipment manufacturers, pharmaceuticals, etc.—that would love to own and control utilities, but cannot do so under PUHCA. One of the biggest and most vocal lobbyists for PUHCA repeal, for example, is not a utility holding company, but Berkshire/Hathaway.

Q. DID YOU LEARN ABOUT PUHCA WHEN YOU WERE AT FERC?

A. No. FERC has no responsibilities to enforce PUHCA, and there is very little knowledge about PUHCA at FERC, just as I assume there is very little knowledge about actual practice under the Federal Power Act at this Commission. There is really no reason for there to be. One agency and statute deals with rates for transmission and wholesale sales of electricity; the other deals with the owners and operators of all electric generation facilities used to generate energy for sale, both wholesale and retail (except those specifically exempted); with the owners of transmission facilities, both interstate and intrastate; and with the owners of electric distribution facilities. The Federal Power

Act is confined to most of the continental United States (as will be discussed below, it does not even cover the ERCOT region of Texas). PUHCA, on the other hand, covers the entire world.

Q. WHERE DID YOU ACQUIRE EXPERTISE REGARDING PUHCA?

A. During my seventeen years at the Washington, D.C. office of an international law firm, I represented clients who primarily either developed, or lent money to developers of, electric power plants in the United States and around the world. I helped ensure that they would get proper exemptions from PUHCA.

II. PURPOSE OF TESTIMONY.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to correct some of the incorrect, incomplete or one-sided descriptions of federal policy regarding electric utilities which AEP's employees give in their testimony, particularly Mr. Baker.

Q. IS THAT ALL?

A. No. I will also testify as to why, given the history of PUHCA and the Federal Power Act, and the substantial differences between the purposes and provisions of the two statutes, this Commission may not "watchfully defer" to, or simply rely on policies of the FERC, regarding matters of interconnection, integrated utility operations or "regions," for purposes of mergers and acquisitions under section 11 of the Public Utility Holding Company Act of 1935.

Q. IN WHAT WAY DO YOU DISAGREE WITH THE HISTORY OF FEDERAL ENCOURAGEMENT OF UTILITY INTEGRATION GIVEN BY AEP'S WITNESS (AND EMPLOYEE), J. CRAIG BAKER?

A. For one thing, Mr. Baker totally ignores the long history of power pools in the United States, and acts as though the idea of such pools, reincarnated as RTOs or ISOs, is a recent and extraordinary development that completely changes the operations of utility systems. In fact, the "1964 National Power Survey" that he refers to in his testimony discussed the then existing power pools, which were several in number, including PJM.. Of course, elsewhere Mr. Baker admits that the model for RTOs is the PJM Pool, which has existed for many years. (AEP Exh. No. 5 at p. 28). Yet Mr. Baker acts as though RTOs and ISOs (which, by his own admission at p.28, are trying to replicate the PJM Pool) have created entirely new forms of utility interconnections and operations. In fact, they are just trying to do what the power pools have long done in a cheaper fashion. (See, testimony of J.A. Casazza, Public Citizen Exhibit 1.)

Q. DO YOU DISAGREE WITH OTHER PARTS OF HIS TESTIMONY?

A. Yes. Mr. Baker says that the passage of the Public Utility Regulatory Policies Act ("PURPA") in 1978 "introduced an element of increased competition into the electric utility industry," *viz.,* "qualifying facilities" under PURPA. In fact, qualifying facilities ("QFs") had nothing to do with competition. The purpose of qualifying facilities under PURPA was to help the United States to decrease its dependence on foreign oil supplies which then, as now, created problems for the nation when there was a decrease in foreign supplies. Indeed, FERC itself tried to deny QFs equal transmission rights as a condition in a 1991 merger case because QFs would have "an unwarranted competitive advantage," since utilities are required to purchase power from them. The court rejected FERC's attempt to discriminate against QFs because they might have competitive advantages. *Environmental Action Inc. v. FERC,* 939 F.2d 1057 (D.C. Circuit 1991).

Q. WERE UTILITIES SUPPORTIVE OF QUALIFYING FACILITIES?

A. No, they were not. Utilities launched a major legal action against FERC's rules granting QFs certain rights. The United States Supreme Court case that finally upheld FERC's QF rules was *American Paper Institute v. American Electric Power Service Corp*, 461 U.S. 402 (1983).

Q. WHY WERE PURPA "QUALIFYING FACILITIES" CONSIDERED "ANTI-COMPETITIVE" BY FERC AND UTILITIES?

A. In order to encourage certain renewable resources and the efficient use of fossil fuels through using the same fuel twice in co-generation, Congress gave QFs certain special rights. Because of these special rights, FERC and the utilities considered them to have "unwarranted competitive advantages."

Q. WHAT WERE THESE RIGHTS?

A. First, utilities were required to buy power from QFs at the utility's "full avoided cost," the cost the utility would otherwise incur; second, utilities were required to interconnect with QFs; and third, QFs were exempted from regulation under PUHCA, the Federal Power Act and state laws regarding rates and the financial and organization of utilities.

Q. WERE THERE OTHER SPECIAL RULES?

A. Yes. One of the most important was that utilities could only own and control up to 50% of QFs, because of the obvious conflicts of interest if they had to buy power from QFs.

Q. WAS IT EASY TO OBTAIN INTERCONNECTION FOR QFS?

A. No, it was not. Just as it was difficult to negotiate the "avoided costs," it was often difficult to negotiate the construction and payment for an interconnection line. And the transmission service had to be "firm," of course, since otherwise the QF could not successfully sell its power, and thus could not finance construction of its power plant.

Q. SINCE THERE WAS A STRONG FEDERAL LAW AND FEDERAL RULES SUPPORTING QFS, DIDN'T THAT MAKE IT EASY TO OBTAIN INTERCONNECTIONS?

A. No, it did not. The negotiations were still difficult and lengthy, and the construction of the interconnection line had to coordinate with the timing of the construction of the plant or, again, it was not financiable. Even once the power contract and interconnection agreement were signed and the plant and line built, utilities and others often tried to attack the power contracts as being too expensive under current conditions.

Q. WHAT DID YOU LEARN FROM THIS EXPERIENCE?

A. Several things. One is that the mere existence of a federal program and federal law does not mean that the goals of the law, such as transmission interconnections or full avoided cost rates, are actually obtained without substantial effort and legal work. But perhaps the most important thing I learned is that in our "project finance" work, we were not financing electric generation plants, but the long-term contracts which at least appeared to offer revenue stability.

Q. WHY DO YOU SAY "APPEARED TO OFFER" REVENUE STABILITY?

A. As I noted above, long-term QF contracts were (and are) constantly attacked, and although the law was on their side, the QFs sometimes just gave up and agreed to rate

reductions rather than incur the expense and uncertainty of fighting for their legal rights. In other cases, where regulatory commissions changed political parties or regulatory agendas and tried to undo their prior approvals, QFs were forced to fight major legal battles.

Q. WERE YOU INVOLVED IN ANY SUCH LEGAL STRUGGLES?

A. Yes. I believe the most significant one was *Freehold Cogeneration Associates, LP v. Board of Regulatory Comm'rs of State of N.J.*, 44 F.3d 1178 (3rd Cir.1995), *certiorari denied, Jersey Central Power & Light Co. v. Freehold Cogeneration Associates, L.P.*, 516 U.S, 815 (1995). The first law firm that brought that case was thrown out of the Federal District Court on three different jurisdictional grounds. However, we were able to persuade the Court of Appeals not only that they should take the case, but rule in our QF client's favor, which they did. But there were many other challenges to long-term QF contracts, despite the very clear federal law and rules supporting them.

Q. WHAT IS THE RELEVANCE OF THE QF EXPERIENCE TO THIS CASE?

A. Aside from rebutting Mr. Baker's suggestion that QFs introduced "competition" to electric rates, I am trying to show that the "contemporary realities" of FERC programs and policies, on which AEP and the Division appear to primarily rely in their narrative statements, require a lot more than mere theory and policy before they constitute "realities."

Q. WHAT ABOUT "EXEMPT WHOLESALE GENERATORS"?

A. From my view from inside the industry, Exempt Wholesale Generator (EWG) status was demanded by the utilities because they could only own 50% of QFs and they wanted to own 100%. Instead, they got EWGs.

Q. DID CONGRESS GIVE EWGs THE SAME RIGHTS AS "QFs"?

A. No, they did not. Contrary to what Mr. Baker suggests in his testimony at p. 24, the only thing that Congress exempted EWGs from is PUHCA. The 1992 EPACT added section 32 of PUHCA to exempt persons exclusively engaged in the business of owning and operating electric generators that sell exclusively at wholesale. Congress did NOT exempt such generators from the Federal Power Act or state laws, did NOT require utilities to purchase from them, and did NOT change the way the rates for such power would be determined, as they did for QFs.

Q. DIDN'T THE EPACT ENCOURAGE MARKET RATES?

A. No. The EPACT made no changes to the way wholesale sales were generally regulated at FERC. Indeed, the EPACT, by adding FPA section 214, actually *increased* the regulatory scrutiny to be given EWG rates, under section 205 of the FPA, when selling to their utility "affiliates" or "associates" as those terms are defined under section 2(a) of the Public Utility Holding Company Act of 1935.

Q. WHAT ABOUT FERC'S TRANSMISSION AUTHORITY?

A. The EPACT made some small increases to FERC's ability to order transmission. However, these were so small and time-consuming that FERC went back to the unduly discriminatory provisions of sections 205 and 206 of the Federal Power Act when it issued its "open access" transmission rulemaking in Order No. 888.

Q. DO YOU AGREE WITH MR. BAKER THAT ORDER NO. 888 WAS "REVOLUTIONARY"?

A. No, I do not. As noted above, the legal basis for Order No. 888 is the unduly discriminatory provisions of sections 205 and 206 of the Federal Power Act, which have remained virtually unchanged since 1935. Courts have not allowed utilities to "refuse to deal" in offering transmission service since *Otter Tail Power Company v. United States,* 410 U.S. 366 (1973). Moreover, the courts suggested that the unduly discriminatory provisions of sections 205 and 206 could be used successfully to overcome a refusal to "wheel," or transmit power, with a proper showing of undue discrimination as early as 1978 in *Richmond Power & Light v. FERC,* 574 F.2d 610 (D.C.Cir. 1978). (In that case, AEP's Indiana & Michigan utility refused to offer transmission to the City of Richmond, Indiana, but the court found that Richmond had failed to take advantage of its opportunity to make a case of undue discrimination.) Finally, FERC frequently required utilities to grant "open" transmission as a condition of mergers, as can be seen in the *Environmental Action* case above.

Order No. 888 certainly made it administratively easier to apply for transmission service under sections 205 and 206, but the transmission still has to be available, still has to be contracted for, and still, in many cases, has to be built, and there are serious arguments as to who should pay for it and how much. Order No. 888 has not automatically solved all transmission access problems by any means.

Q. DO OTHERS AGREE WITH YOU THAT ORDER NO. 888 HAS NOT ELIMINATED ALL PROBLEMS IN OBTAINING TRANSMISSION?

A. Yes. New FERC Commissioner Joseph Kelliher, who served as Secretary of Energy Abraham's liaison to Vice President Cheney's Energy Task Force prior to joining FERC, has recently stated that changes need to be made to Order No. 888 because of the difficulties that still remain for parties to obtain actual transmission under it. See Attachment A.

Q. DO YOU AGREE WITH MR. BAKER THAT "REGIONAL TRANSMISSION ORGANIZATIONS" OR "RTOs" HAVE SUBSTANTIALLY CHANGED THE WAY UTILITIES INTERCONNECT?

A. No, I do not. As noted above, Mr. Baker testifies at p. 28, that the model for RTOs and ISOs is the PJM Pool which has been around for a long time. Tight power pools have certainly been good at interconnecting different utilities for purposes of exchanging excess utility sales of power, but they were never considered as changing the way a single integrated utility system interconnected with its own facilities and customers, its "native load." In other words, RTOs and ISOs really represent nothing new for PUHCA purposes.

In any event, RTOs and ISOs are still voluntary, and AEP's various affiliated utilities may or may not be a member of one at any given time. However, as Mr. Casazza testifies, mere membership in an RTO or ISO does not result in "interconnection" as an integrated electric system anymore than membership in a tightly controlled power pool used to do.

Q. WHAT ABOUT MR. BAKER'S SO-CALLED "THIRD STAGE" OF FERC PROGRAMS, THE "STANDARD MARKET DESIGN"?

A. FERC's proposed Standard Market Design proposal, or SMD, has so outraged many state utility commissioners and their congressional representatives that it seems unlikely to go anywhere without new legislation. There is also a serious question as to whether FERC-- which was specifically given no jurisdiction over generation in the Federal Power Act, and which has no authority to compel sales of energy or power-- even has the statutory authority to institute a "standard market design."

However, regardless of whether the SMD ever becomes reality, it again has no bearing on what constitutes a "region" under PUHCA. Utilities have long been able to sell power to neighboring utilities, and to distant utilities, without calling this exchange a "market." The ability to exchange power has never meant, and still does not mean, that every utility that another utility can reach via a transmission line is in the same "area" or "region" of the country. Indeed, such an interpretation would render section 11 of PUHCA completely meaningless, and a statute cannot be interpreted in such a way as to render meaningless it's most important section, the "heart" of the Act.

Q. WHY DO YOU CALL SECTION 11 THE "HEART" OF THE ACT?

A. Because the men who wrote and enacted it considered it that. The Senate Report accompanying the Act called section 11 "the very heart of the title," and said that its purpose "is simply to provide a mechanism to create conditions under which effective Federal and State regulation will be possible." Senate Report at p. 11. The utility industry, on the other hand, considered it "the death sentence," since it "sentenced" holding companies to owning a single, integrated utility system.

Q. HAVE UTILITY HOLDING COMPANIES EVER TRIED TO REPEAL SECTION 11?

A. They have tried since at least 1935. When then SEC Chairman William O. Douglas left the Commission to join the United States Supreme Court, he wrote to President Franklin D. Roosevelt:

> "There is still some desire in the industry to alter the provisions of the 'death sentence', particularly Section 11(b)(1). Any such attempt should be vigorously opposed. That section is soundly conceived. It is practical and workable. When fully executed it will provide a large degree of decentralization in the utility industry and cause a return of that industry from Wall Street to Main Street."

(See attached copy of letter supplied by the Library of Congress from the William O. Douglas papers, Attachment B.)

Q. WHAT TO YOU BELIEVE DOUGLAS MEANT BY "DECENTRALIZATION" AND A RETURN OF UTILITIES "FROM WALL STREET TO MAIN STREET"?

A. PUHCA was designed to break up the huge utility holding companies that owned utility properties scattered across the nation and return them to local owners and management, and to try to confine their operation to single states so that state commissions could effectively regulate utility rates. FDR as the Governor of New York had discovered first hand how multi-state holding companies could prevent effective state regulation of utility rates. Also, investment banks had become highly involved in the purchases and sales of utility assets and in issuances of utility securities, from which transactions they earned large fees, so "Wall Street" was controlling utilities rather than "Main Street." PUHCA is a "local control" statute.

Q. DOES PUHCA LIMIT THE SIZE OF UTILITY HOLDING COMPANIES?

A. Yes. The definition of "integrated public-utility system" in section 2(29) of PUHCA says the system must be "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." Chairman Douglas wrote an article on "Scatterization" in which he described how PUHCA would limit the size of utility holding companies, because as each tried to expand, it would bump up against the borders of its neighbors, and thus be limited in size.

Q. WHY DO YOU SAY THAT THIS COMMISSION CANNOT "WATCHFULLY DEFER" TO WHAT THE FERC DOES IN MERGER CASES?

A. The merger provisions of the two statutes are completely different. PUHCA mandates very specific, structural limitations on the mergers of utility holding companies. The Federal Power Act has none; it permits FERC to approve transmission and wholesale contract mergers under a general "public interest" standard.

Q. ARE THERE OTHER REASONS THAT THE TWO STATUTES ARE DIFFERENT?

A. Yes, they are completely different. The Federal Power Act is simply a standard, Interstate Commerce Act rate regulation statute that requires the filing and review of rates for interstate transmission and wholesale sales of electric energy. It was passed in 1935 to fill the "gap" that existed because the state commissions, which regulated most electric rates, could not regulate electricity sales between states. The Holding Company Act, on the other hand, has been called one of the most sweeping pieces of legislation ever enacted outside of wartime. As noted above, it covers the entire world, and it covers not just utilities, but any other industry that attempts to own and control utilities. The Federal Power Act doesn't even cover Alaska, Hawaii, or most of Texas, and Congress specifically gave FERC no jurisdiction over electric generation and distribution facilities.

Basically, FERC has jurisdiction over transmission and contracts for wholesale sales, period.

Q. DID CONGRESS REFERENCE THIS STATUTORY DIFFERENCE?

A. Yes. Congress stated in section 318 of the Federal Power Act that whenever the two agencies had jurisdiction over the "same matter," the provisions of the Public Utility Holding Company Act would control.

Q. HAWAII AND ALASKA SEEM OBVIOUS, BUT WHY DOESN'T FERC HAVE JURISDICTION OVER ELECTRIC UTILITIES IN MOST OF TEXAS?

A. My home state, the Great State of Texas, likes to be independent. As a result, it refused to interconnect electrically with the rest of the country in order to avoid wholesale electric rate jurisdiction under Part II of the Federal Power Act. Since the FPA only covers transmission in interstate commerce, Texas refused to allow most of its utilities to transmit energy outside the State of Texas. The ERCOT region of Texas is therefore not subject to FERC jurisdiction.

Q. IS THERE NO ELECTRIC CONNECTION AT ALL?

A. Well, back when I was at FERC, there was an attempt to interconnect Texas that was called the "midnight wiring." Someone at one of the CSW utilities apparently "closed" a switch between Texas and Oklahoma in the middle of the night, thereby causing power to flow in interstate commerce for a number of hours. This was unsuccessful in bringing Texas into the Union electrically, however. There was also a case involving whether the river separating Texas and Oklahoma had shifted, thereby causing certain lines to be in interstate commerce. This led to a Supreme Court case

deciding the official borders of Texas and Oklahoma, but didn't change the electrical status.

Q. SO, WHAT HAPPENED?

A. Someone managed to get legislation passed providing that if a utility was *ordered* to interconnect, this would not subject it to FERC's general jurisdiction. Section 201(b)(2) of the FPA provides: "Compliance with any order of the Commission under sections 210 or 211, shall not make an electric utility or any other entity subject to the jurisdiction of the Commission for any purposes other than the purposes specified in the preceding sentence." This resulted in a Texas interconnection case at the FERC in which it was decided that two DC ties would connect ERCOT utilities to the rest of the country under this provision, thus leaving ERCOT electric wholesale sales and transmission outside the general jurisdiction of the FERC.

Q. DOES THIS REMAIN THE LAW TODAY?

A. Yes.

Q. SO FERC DOES NOT EVEN HAVE JURISDICTION OVER THE PORTION OF THIS MERGER THAT INVOLVES ERCOT UTILITIES?

A. FERC has no jurisdiction over mergers of electric utilities in Texas. Actually, FERC has no jurisdiction over mergers of generating utilities *per se* anywhere, since it has no jurisdiction over generation. It's jurisdiction over mergers is usually limited to transmission facilities and wholesale sales contracts.

Q. ARE THERE OTHER LIMITS TO FERC'S MERGER JURISDICTION?

A. Yes. This Commission under PUHCA has jurisdiction over mergers between electric and natural gas utilities; FERC does not. This Commission under PUHCA has

jurisdiction over attempted holding company acquisitions by foreign companies; FERC does not. This Commission under PUHCA has jurisdiction over attempted acquisitions of utilities by non-utility companies; FERC does not. As noted above, FERC was specifically denied jurisdiction over electric generation and distribution facilities.

Q. DOES THE HOLDING COMPANY ACT COVER TEXAS?

A. Yes. PUHCA is not based on interstate electric transmission, but on general interstate commerce, so it covers Texas and has done so since 1935. PUHCA also covers Alaska and Hawaii, unlike the FPA, and also covers the rest of the world, if companies operating there wish to own utilities in the United States. That was a large part of my job at the law firm, explaining to astonished companies, and even countries, that they were subject to PUHCA if they wanted to own utilities in the United States.

Q. DOES ERCOT OPERATE THE TRANSMISSION OF UTILITIES WITHIN IT?

A. Yes, and I note that a grand jury subpoena has recently been issued regarding this operation. See, Attachment C.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

Attachment B

By messenger

April 12, 1939

The President
The White House

My dear Mr. President:

You recently asked that before I left my post as Chairman of the Securities and Exchange Commission I give you my views on the statutes administered by the Commission. I am very happy to do so.

First, as to the Public Utility Holding Company Act of 1935. Over the years minor amendments may be desirable in light of administrative experience. But in my opinion none is now necessary. The statute has proven to be workable and sound. Substantial progress has already been made under it. There is still some desire in the industry to alter the provisions of the "death sentence", particularly Section 11(b)(1). Any such attempt should be vigorously opposed. That section is soundly conceived. It is practical and workable. When fully executed it will provide a large degree of decentralization in the utility industry and cause a return of that industry from Wall Street to Main Street.

Second, as to the Securities Act of 1933. The issuance of over fifteen billion in securities issues through the machinery of this statute is ample evidence that that machinery is neither unworkable nor excessively burdensome. Stoppage of at least a quarter of a billion dollars of fraudulent issues demonstrates its protection to investors. The importance of this statute in requiring the full truth about securities when they are first offered to the public is so great that changes in it along the lines proposed by Wall Street would not be constructive. Rather, they would be disastrous to investor safety and confidence.

The earlier 1934 amendments, in my opinion, did more than eliminate ambiguities and uncertainties. They substantially weakened the statute. At some time in the future there doubtless are improvements which can be made in the Securities Act of 1933. But these are minor in character. Under no stretch of the imagination could they be called substantial nor placed on any list of items for a recovery program. In my opinion, representations that amendments to the Securities Act would facilitate recovery are misleading.

Third, as to the Securities Exchange Act of 1934. Section 9 of this statute has proven effective in ridding our securities markets of various forms of manipulation. It should not be altered by even a comma. The protections in Section 16 against trading by corporate insiders have likewise been effective. It should not be altered in any respect whatsoever. Although artificial stimulants to market activity have thus been eliminated, regulation has not interfered with the free play of the forces of supply and demand. Experience with this statute over a period of five years shows a combination of sufficient flexibility for the needs of finance and adequate safeguards for the protection of investors, so that there is no need for alteration of any of its provisions. Recent proposals of the Hancock Committee (attached hereto as Exhibit A) would weaken the statute beyond repair, as indicated in my statements made on March 15, 1939, which I attach as Exhibits B and C. Any such proposal having the purpose or effect of permitting the professionals or the insiders to have another "party" would be fatal from the viewpoint of investors.

On only three points would I qualify the foregoing comments. First, I believe that eventually it should be possible to merge or consolidate the various registration or reporting requirements of the three Acts to the end that information filed by a corporation under one statute would serve the purposes of all three statutes. This, however, is a technical task for legal draftsmen at some future time in a different climate of opinion.

Second, experience has shown that there is an area in stock exchange administration which can neither be effectively governed by self-discipline nor by the statute, as it now stands. I refer to matters of exchange discipline over their most powerful members. You will recall that during the course of our investigation of the failure of Richard Whitney, testimony was presented indicating that

although certain members knew, substantially in advance, of Richard Whitney's defalcation, they took no steps to inform either the authorities or the Exchange of the situation. The Securities Exchange Act did not give the Securities and Exchange Commission authority to discipline such members for such conduct. It was therefore determined to refer the matter to the New York Stock Exchange as had been the practice in other comparable situations. The letter of reference is attached hereto as Exhibit D. But the management of the New York Stock Exchange was unable or unwilling to take any action. Their letter is attached hereto as Exhibit E. Their failure to act resulted in the resignation of Robert M. Hutchins, one of the "public" governors of the New York Stock Exchange. His resignation was in protest against the failure of the Exchange to take any action in that case. After his resignation and on January 26, 1939, he wrote me as follows:

> "It is my considered opinion that the real reason for the inaction of the Stock Exchange was that influential and important people were involved in this case. Under the constitution as it was at the time of the incident the persons, among others, who might be disciplined were J.P.Morgan and Junius Morgan, who held the seats for J.P.Morgan and Company. No member of the Board of Governors was willing to 'lay his head on the chopping block' by raising questions about J.P.Morgan and Company and similar influences in the Street. This result seems to me inherent in the situation. No private voluntary organization can ever discipline the 'big men' among its membership. Some outside impartial agency has to do that. The contradiction involved in the present status of the Stock Exchange is that it appears before the public as a public institution, but actually on issues like this conducts itself as a private organization, subject to all the handicaps of such an organization. In cases like the Sisto case the Exchange will be vigorous and decisive. In cases like the Whitney case it will do nothing at all."

I agree with his diagnosis. It has been verified by me from independent sources. It seems clear, therefore, that the law should be amended so as to give to the Securities and Exchange Commission authority to act in such cases and to take off the hands of the stock exchanges cases which they have found "too hot to handle". Otherwise, there will be no assurance that discipline will be meted out equally and fairly, regardless of the social or financial importance of the members in question.

In the third place there is the problem of margin trading. It is my opinion that regulation of margin trading should not be weakened. There are some who persist in thinking that lightening of those requirements would aid the markets. I am confident of one thing and that is that such lessening of regulation would not aid the investors. In fact it is my belief that margin trading should be abolished.

These are personal opinions of mine based on my experience with and observations of the statutes which this Commission administers. I speak only for myself, not for the Commission.

To round out the work of the Commission in the field of finance it seems to me that at least three additional measures are needed.

The first is the Trust Indenture Bill designed to eliminate material conflicts of interest from corporate trustees and to make such trustees more active in protection of the interests of security holders.

The second relates to investment trusts, reports on which have been going up to the Congress from the Commission since last fall. This has been one of the most careful and painstaking studies which the Commission has undertaken. The investment trust, at least in the form in which it is organized, has been one of the most defective and dangerous instrumentalities for investors which the 1920's produced. Drastic legislation is needed if the investment trust is to be preserved at all.

The third involves an extension to issuers of securities traded over-the-counter of the same regulation which issuers of securities registered on stock exchanges presently enjoy. The same reasons which make the stock exchange regulation necessary and desirable from the point of view of investors obtains equally in the over-the-counter field. Furthermore, such regulation would equalize the competitive conditions existing between the stock exchanges and the over-the-counter brokers and dealers. Equalization should be obtained in that way, certainly not through emasculation of the Securities Exchange Act as proposed by the Hancock Committee.

This program would, as I have indicated, help to round out the work of the Commission in the field of finance and would still keep it within permissable size limits.

Along the lines of our conversation, I am sending copies of this letter to Hon. Robert F. Wagner and Hon. Sam Rayburn, in view of their deep interest in these regulatory measures.

Yours faithfully,

William O. Douglas,
Chairman

Douglas bk

APR 14 1939

P

Attachment d

The Miami Herald
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Grand jury to review ERCOT

Associated Press

AUSTIN - A judge on Tuesday swore in a grand jury and appointed special prosecutors to review allegations of wrongdoing at the Electric Reliability Council of Texas, which operates the state's electric grid.

State District Judge Michael Jergins acted on the request of Williamson County District Attorney John Bradley, who had been reviewing alleged contract irregularities at ERCOT.

"After examining that evidence and collecting additional documents, I found that this matter deserves the full time attention of a grand jury and a team of investigators, accounting experts and prosecutors," Bradley said.

Bradley said prosecutors from Texas Attorney General Greg Abbott's office will take over the investigation.

ERCOT is not-for-profit organization that is financed through a fee on residential electric bills. Though ERCOT is independent, the state Public Utility Commission has some oversight over ERCOT.

ERCOT officials have said that some employees were either fired or resigned when an investigation indicated inappropriate contracting relationships by some employees in ERCOT's information technology group last spring.

Officials have revealed few other details, though ERCOT Board Chairman Mike Greene has said some employees set up a shell corporation, subcontracted work out and then scammed money.

"We are very pleased with the district attorney's recommendation for additional resources to investigate the activities of these former employees. We have been fully supportive of the investigation, and we will continue cooperating in every way. We're eager to see the wrongdoers brought to justice," said Margaret Pemberton, ERCOT vice president and general counsel.

Audits on ERCOT released this month said that ERCOT lacks a formal set of policies and procedures for most of its key business processes and needs improvement in the same area on cybersecurity issues.

One of the reports said that ERCOT policies, procedures and internal controls for most key business processes have not been formalized or adequately documented and communicated to employees. That has resulted in employees not fully understanding or applying policies consistently, the audit said.

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