INSTITUTIONAL INVESTORS

An Address by

THE HONORABLE MANUEL F. COHEN

Chairman, Securities and Exchange Commission

Before the First Annual

Institutional Investor Conference

New York City

January 31, 1968

The size of this audience reflects the interest in and importance of the issues to be explored in this conference. It would be presumptuous for me to suggest all the answers, even if I could. In fact, as I looked through the announcements of this conference, I was awed by the magnitude of the concepts to be discussed. Such terms as "institutionalization", "performance", "investment strategy", "conglomerate", "economic environment", "inflation" and the like were liberally sprinkled through the announcements.

I do not mean to imply that there is anything wrong with using such terms, or that I have any doubt as to the practical utility of these meetings to those who attend them. What I do want to suggest is that through continued use and repetition of these words, there is a danger that we may not see the trees for the forest; we may come to focus on the words and the glittering images they project rather than on the substantive problems imbedded in them.

These words and concepts, of course, are simply ways of describing relationships -- some new, some old -- among people in an increasingly complex society and economy. It is with the reality of these relationships and with people's rights, expectations, duties and obligations, that the Commission, as a government agency, and all of you, must be concerned. We should recognize the danger that the use of big words sometimes tends to confuse questions of right and wrong. It may also obscure the nature of fiduciary and other responsibilities. Finally, it may make harder, rather than easier, the urgent need to identify, to analyze and to resolve the real questions; and it may make impossible articulation of the rights and obligations of the various persons and organizations involved or affected by the processes, concepts and goals listed for discussion.

Since this entire program will be devoted to something called "institutional investors", I suppose we might start by inquiring what an institutional investor is and what relationship it creates and encompasses. Reduced to its simplest terms, I would suppose that it is an entity of some kind which enables

a small group of people to exercise power over the combined savings of a large group of constituents. The principal manner in which this power is exercised is by engaging and disengaging the interests of the constituents in fleeting or more lasting relationships and transactions with other persons, and with other institutions managed by other small groups of people for other constituents. These constituents are variously called "stockholders", "employees", "customers", "beneficiaries", "policyholders" and the like. (What I have just said is, of course, a longwinded way of saying that institutional managers direct the purchase and sale of stocks and bonds for other persons. But I think it is important to make clear that these managers are rapidly becoming the most significant elements in our securities markets and that their apparently simple transactions affect the interests of large numbers of people who have placed their faith and confidence in these managers.) There is no time for me to discuss the significant role these institutional managers are playing in what Father Harbrecht has described as the "paraproprietal" system of corporate development and property ownership or to indulge in what can be a fascinating consideration of its implications.

Of course, even if one views the transactions directed by these managers solely as purchases and sales of securities, they are still not simple. The ingenuity of institutional managers, as applied to an ostensibly rigid commission rate structure for transactions in listed securities, has led to the development of some very imaginative techniques whereby large amounts of commission money are channeled to people who have performed services of various kinds which benefit the managers but which are usually not involved in the execution of the particular transactions on which the commissions were charged. This is one area where concentration on the "institution" has obscured the basic personal obligation of the managers to seek the best price on behalf of their constituents, an obligation which encompasses a duty to seek the best execution at the most reasonable cost. I have even heard it suggested that any of the techniques currently used, or which may be devised in the future, to divert excess commissions -- assets of the constituents since they can be used to reduce costs of execution -- to the use or for the benefit of the manager, are all right so long as they are disclosed -- fully disclosed in all their complexity.

I would be the last person to quarrel with disclosure -- it is a most effective method of dealing with certain needs of investors and with certain types of improper activities. But it is not -- and was never intended as -- a substitute for fulfillment of fiduciary and professional responsibilities, especially where one is dealing with transactions effected or directed by highly sophisticated managers on behalf of widely scattered and unsophisticated investors. This is implicit in the antifraud provisions of all the securities statutes, which reflect the view that disclosure alone, particularly disclosure of a highly technical nature in complex documentary materials, does not afford adequate protection, and that substantive controls are required to make that disclosure meaningful and to assure compliance with basic fiduciary obligations. As long ago as 1940, in the Investment Company Act, Congress explicitly spelled out certain responsibilities of persons acting in a fiduciary relationship to investment companies. The time usually involved in the development of appropriate rules under general antifraud provisions was deemed too slow to meet the sharp conflicts of interest found in the structure and management of the investment company industry.

What are the other responsibilities of institutional managers to their constituents? To answer that question, we should recall why people are persuaded to put their savings into these institutions. One reason is that they are not inclined to spend the time and effort necessary, or do not consider that they have the competence, to choose direct investments; another reason is the expectation that institutional managers will cause their savings to grow faster or more steadily than if they invested them directly in income producing property or securities. An important reason, frequently overlooked, is the hope that, by accepting institutionalized and impersonal advice through the pooling of relatively small sums contributed by many, the investor will enjoy the benefits normally available to organizations that can bring to bear the strengths and advantages of large size and large transactions.

Another consideration has been the general assumption, at least until recently, that these savers were by and large conservative investors, that the relative safety of their investment was of paramount importance to them, and that they were merely looking for the highest rate of return consonant with that fundamental objective. And, I suspect, a great many, if not most, investors are still of that persuasion.

In the very recent past, however, it has become apparent that there is increasingly wide appeal in institutions which offer their constituents a far more speculative, far more aggressive, attitude toward investing. Whether this is a normal and natural by-product of an "affluent society", a desire on the part of a large number of people to get excitement from their investments that may be lacking in other aspects of their lives, or simply a desire for "wealth beyond the dreams of avarice", I am not prepared to say. What I can say is that more investors are apparently looking for dramatic short-term growth, high risk, leverage -- in short, they are seeking to live dangerously, and many are doing it through the medium of institutions. I might add: there appears to be no shortage of institutional managers who are prepared to satisfy -- and in many cases to foster -- that demand. And, we must recognize that, in most cases, it is too expensive or otherwise not feasible to speculate in the securities of the institutions themselves. In fact, the ability of the ordinary participant in these institutions to disengage himself from the institution is severly circumscribed either by the economics of the relationship or because of other restrictions built into these relationships. However, I do not wish to leave the impression that this point of view and activity is limited to institutions or that this development has not resulted in certain questionable practices. I am sure many of you have noted the increasing attention paid to such activities by the SEC and by other regulatory and enforcement agencies.

Our securities laws have traditionally been neutral toward short-term traders and speculators -- that is, people who buy and sell securities not because of a long-range interest in the issuing company but because they believe that, for one reason or another, the price of that security will go up or down sharply within a relatively short period of time. Indeed, some argue that, if kept under salutary controls to prevent manipulation and other types of overreaching and unfair conduct, short-term traders may provide needed liquidity and continuity to a market. I might add that these arguments for needed liquidity strike an odd note in these days of volume beyond the most psychedelic dreams of any exchange official or market traders. In recent days you have heard many voices raised in warning against the dangers inherent in speculation -- dangers to the speculators, to our markets and to the economy.

But indirect speculation through institutions as we see it today -- what I might call "vicarious speculation" -- is a relatively new phenomenon and seems to me to pose at least two very serious additional dangers.

In the first place, the price of speculation is often disillusionment. Speculation, by definition, carries with it the possibility of substantial loss as well as substantial gain. But if a man's own speculation turns out badly, that disillusionment may well be directed inward, at least if the Commission, the states, the self-regulatory agencies, and other enforcement agencies have done their jobs well enough so that his disillusionment cannot fairly be attributed to inadequate policing of misrepresentation, market manipulation or other unfair activity. But, in the case of institutional or "vicarious" speculation, the disillusionment of investors who suffer substantial losses will most likely be turned against the people they consider responsible -- the institutional managers to whom they have turned for sophisticated and professional management and to whom they have paid exceedingly generous charges and fees -- and, because of greater distance from them, against the securities markets generally. For these and other reasons, I believe the new fashion contains a serious potential danger to continued public confidence in the securities markets, particularly since institutional trading is rapidly becoming, at least in some markets, the most important influence on market trends and prices.

In the second place, the man or group of men who can speculate with the combined savings of thousands, or hundreds of thousands, of investors is not solely a potential danger to his constituents. By virtue of its size, the manager of the institution is a much greater threat to other traders, and to investors generally, than is the individual speculator trading solely for his own account or for the accounts of a few others. The parallels to the problems created by speculative activities of pools and syndicates in the nineteen-twenties and thirties are obvious and have been mentioned by others concerned with these developments. Indeed, some think that speculation, by similarly motivated and informed managers, if done on a large

enough scale in a small enough market, can almost guarantee its own success. We must, therefore, also be concerned with the potential disillusionment of investors who did not invest through speculative institutions, but simply got trampled by them. If the markets are to continue to provide a necessary ingredient to successful investment, institutional managers should consider the effect of their actions not only on the constituents but also on the public with whom they share the public facilities of the market places. We have more to do in defining and articulating these relationships and obligations as well as the current and potential problems and dangers.

As the agency charged, in a broad sense, with a responsibility for maintenance of public confidence in the honesty and, within limitations, the orderliness of the securities markets, the Commission cannot ignore the dangers inherent in the present situation. It is for this reason that we believe it important to initiate a far-ranging economic study of the impact of institutional investors on the securities markets. We must, of course, take into account fiscal stringencies. Nevertheless, we hope that we will have the full support of the Congress in this undertaking and an appropriation that will enable us to do the kind of job that is required. In any such study we would seek and, I anticipate we will get, not only the cooperation but also the most active participation and assistance from each and every industry interested and concerned.

The Commission cannot solve all of the problems alone. Self-regulation and enlightened self-restraint have always been a keynote of securities regulation. I hope that, as you contemplate all the golden eggs that will be laid before you in the course of this conference, you will give much thought to the ways in which all the participants, and the institutions, in what we describe as the securities markets can and should assist in assuring the continued health and well-being of the goose.

There are great rewards -- psychological as well as financial -- in handling the vast sums of money that are accumulated in investment institutions today. I am sure that many of the supposedly great moguls of the past would envy you your power and positions. I would simply urge the managers of all

the institutions, whether or not represented here today -- both those that invest and those that are invested in -- to consider carefully their relationships and obligations to those for whom they act and those whom their actions affect. I think you understand the needs and the expectations of the members of the investing public. You must also be aware of, and sensitive to, the dangers to them, to you, and to the country if you let them down.