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INSTITUTIONAL INVESTORS AND THE SECURITIES MARKETS: A REGULATOR'S VIEW

An Address By

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It is fashionable in January to review and forecast. Economists and market sages are particularly prone to January forecasts; this urge resembles the urge to make New Year's resolutions, generally with similar results.

Judging from the more than usual hedging of those economists brave enough to permit themselves to be quoted publicly, this January is a particularly difficult spot from which to launch a forecast. Fortunately, the expanded responsibility being suggested for the Securities and Exchange Commission by legislators and some industry leaders does not include a requirement for the Chairman to forecast the DJIA on next December 31. However, it can be argued -- particularly since I have the temerity to accept an invitation to speak to an audience of forward-looking thinkers -- that I have some responsibility to forecast the form of the future stock market, if not the level. Furthermore, there was an implicit assumption in my accepting this job in the first place -- that I was concerned about the apparent problems of the securities markets and how change might be effected.

As you know, we currently face very major changes in the structure and components of our securities markets. The fixed commission system, which has prevailed on the New York Stock Exchange since the days of the Buttonwood Tree, is in the process of being dismantled in favor of competitive, or unfixed, commission rates. A central transaction system and consolidated reporting process is under development to link together all markets for similar securities. The physical clearing and transfer of securities necessary to complete transactions is undergoing major automation and streamlining, as are the facilities for the deposit of securities held by broker-dealers and banks.

Other developments are also affecting the securities marketplace. The information provided to investors under SEC rules, which has been expanded and improved steadily over the years, may soon include subjective data for the first time -- evaluations, estimates and forecasts by public companies of their recent results and future

expectations. Important new types of securities, such as variable life insurance contracts, may be close to introduction and older investment vehicles -- security options -- have acquired a new popularity due in large part to the efforts of the first new securities exchange in 12 years and the second since the securities laws were passed by Congress.

Furthermore, in recent years the participants in the securities markets have changed importantly in form and relative significance. This audience, I know, is intimately familiar with the growing role that the institutional investor is playing, and therefore you were probably less surprised than many in 1973 when it became apparent that the major institutional investors were bank trust departments, and not the investment companies which Congress isolated for SEC regulation.

Actually, the information should probably not have come as the great surprise that it apparently was in certain quarters. In our Institutional Investor Study Report, published in March 1971, we had observed that, at the end of 1969, trust departments of commercial banks administered assets having a market value of approximately $280 billion. The portion of these assets invested in common stock, amounting to $180 billion, exceeded the sum of the common stock administered by the investment advisers, insurance companies, self-administered employee benefit plans, foundations, and educational endowments. We also noted a high degree of concentration in management of trust funds. At the end of 1969, the 50 bank trust departments administering the largest amounts of total assets administered approximately $130 billion of common stock, or 70% of the common stock administered by all bank trust departments. Each of the 50 banks administered, at that time, more than $650 million of common stock. It now appears that these dollar amounts are substantially larger, but the order of magnitude and the nature of concentration was already evident.

As you all know only too well, much has been made in the public press, and in congressional committee hearings and reports, of the detrimental features of this growth in institutional investment and concentration of money management. Some persons are concerned about it from an antitrust point of view, fearing the excessive concentration of power through portfolio management, especially when combined with other banking resources, but the aspects that naturally come most to our attention at the SEC are those that have to do with the market impact of institutional trading.

Here, I think, we are all familiar with the complaints that have been raised. Institutional investors are accused of concentrating their investments in a relative handful of stocks, with the result that these are grossly overpriced, while neglecting ordinary issues. In this process they are said to have dried up sources of equity capital for many businesses, especially smaller ones, and depressed the prices of other stocks so that the raising of new equity capital is unattractive if not impossible. Institutional money managers are accused of possessing in marked degree a herd instinct which causes them all to move in and out of

the same stocks at approximately the same time, so that when one sells, the others quickly follow, causing the price of a stock to decline sharply and individual investors to find themselves suffering severe losses without any change in the fundamental factors of a given stock, and even worse, of having this occur quickly before individuals have news and can act. Institutional investors are also accused of having better and possibly illegitimate sources of inside information not made available to the ordinary investor. Finally, institutional investors are said to have got themselves involved in a game of mutual protection in keeping up the prices of the limited number of stocks in which they have invested their portfolios -- the sort of thing that Senator Bentsen refers to as the self-fulfilling prophecy. An institutional money manager predicts that a stock is going to go up, invests in it, other institutions follow his lead. The result is that indeed the price does go up, and there they must all sit -- afraid to sell, lest the price will then go down to everybody's mutual disadvantage. Afraid to sell, also because in some cases there seems to be nobody left to sell. All this we learn is wrong about institutional

investing, at the same time we are aware that institutional trades account for approximately 70% in dollar volume of all trading on the New York Stock Exchange.

I am not at all prepared to say that all of these accusations and complaints are without any foundation. They do point in many respects to serious problems, some of which I will discuss shortly. I think it a mistake, however, at least from a governmental point of view, to approach the institutional investors individually or collectively as bad guys to be punished.

Spokesmen for bank trust departments and other institutional investors have tried to point out, whenever anybody will listen, that in portfolio management they are acting in a fiduciary capacity for individual beneficiaries, many of them frequently people of limited means, who are relying very heavily upon the institutional funds as the source of support for retirement or for similar purposes. As more and more savings are channeled into institutional investment funds of one kind or another, frequently encouraged by our tax laws, as they are in regard to pension plans, it is of great importance to our economy, and indeed, to our whole

society, that these funds not be penalized or crippled, but maintain their value to the extent necessary to enable them to meet the obligations of the employees or other beneficiaries who are relying so heavily upon them.

It may well be, looking back, that institutional investors, particularly the managers of pension funds, have moved too heavily into equity stocks, and concentrated too much on growth stocks that have since failed to grow. If this is true, then it is in the interests of all of us that these portfolio managers be able to extricate themselves in an orderly manner without crushing losses to the beneficiaries.

It has rather surprised me, that with all of the attention that has been paid in the Congress to the institutional investor situation generally, little attention, if any, seems to have been devoted to any legislative standards with respect to portfolio composition, especially of pension funds. Our experience with so-called legal investment laws in the insurance field may not have been an entirely happy one, but something of this nature may be appropriate. Whether or not that is so, the approach, at least of the SEC, to this area is not punitive. It is intended to be helpful.

We believe, for example, and I think this belief is generally shared among those concerned with institutional money management, that a healthy securities market is as important to the institutional investor as it is to anybody else. We also believe that a healthy market requires the active involvement of a substantial number of individuals investing directly for themselves. Therefore, when we argue that the virtue of one or another proposal with respect to the forthcoming central market system will be good because it will encourage individual investors to be active in the stock markets, this should not be taken to mean that all individuals are good and all institutions are bad. That, obviously, is not the case. But institutions need individuals in the market, if we are to maintain capital markets on the sound basis that we have in the past. Accepting this premise, that the trading by many individuals is good for the institutional investors, certain measures seem desirable, among other reasons, for the purpose of reducing the current suspicion with respect to the market effect of the activities of institutional investors, a suspicion apparently entertained by a substantial number of individuals.

One of these measures, which I believe has generally been supported by spokesmen for institutional investors, is an Institutional Disclosure Act. At the request of Senator Williams, the SEC has prepared and submitted a bill that will amend Section 13 of the Securities Exchange Act of 1934 so as to require investment managers of funds above a certain size to make periodic disclosures of the contents of their portfolios, and at least their larger transactions over the period being reported on. We approach this matter in terms of the investment manager and the aggregate funds subject to his management, rather than in terms of individual portfolio size. This seemed to be the relevant consideration for the significance of the information to be extracted.

As to what that minimum size should be, so as to trigger the requirements of the bill, we have suggested initially an aggregate fair market value in equity securities of at least $100 million, with authority in the Commission to reduce that to an amount not less than $10 million. At $100 million, we estimate that we will receive reports from approximately 300 investment managers responsible for about 75 percent of total institutional stockholdings. If the sum went down to $10 million, the number of investment

managers would be several thousand, according to our data. At the moment, initially at least, we do not want to receive several thousand reports of this sort. We wouldn't have the facilities to do anything meaningful with that number of reports, and I doubt that the public would have sufficient interest at that level to justify it. If the program gets going and proceeds well, and we do find useful things to do with the reports, we may consider moving down below $100 million.

The bill would permit the Commission to require the periodic reports as frequently as it sees fit, but not more often than monthly. Transactions would have to be reported that involved more than $500,000, or such other amount as the Commission may by rule determine. For the purpose of this bill, "investment manager" includes any bank or bank holding company or subsidiary thereof, any insurance company or insurance holding company or subsidiary, any investment company, any broker-dealer, or any other investment adviser as defined in the Investment Advisers Act of 1940, and certain other persons. To protect the confidentiality of the trust relationships of banks with individuals, we have suggested a proviso that information identifying the holdings

of equity securities of any natural person, trust or estate, other than a business trust, which is filed with the Commission pursuant to this bill, shall be confidential.

Because of the congestion that is developing in the legislative calendars of both houses of Congress this winter, it is impossible to predict when or whether this Institutional Disclosure Act will become law, but it is something that we very much favor.

Any of you that followed the newspapers last summer are well aware of the fact that Senator Bentsen held hearings before his subcommittee exploring the possibility of some further restrictions upon institutional portfolio activity. The ideas that received the most attention are those that would limit the concentration of portfolios in particular securities, and those that would limit the amount of selling of any given security over a specified period of time. Senator Bentsen himself rather early concluded that the latter idea was not promising, but he did take favorably to the former idea. In late December, he submitted a bill, which is pending in the Congress, that would impose a diversification requirement, at least upon pension funds. The bill is in the form of a tax provision, imposing

unfavorable tax consequences upon a fund that did not meet its standards. The bill applies only to pension funds, and not to other institutional investors; and the percentage limitations in the bill apply to the aggregate assets of all pension funds which are under common management, rather than to the assets of individual funds.

The aggregate pension funds under common management, according to this bill, cannot have more than 5 percent of their total assets invested in any one stock, nor can they hold more than 10 percent of the outstanding shares of any one company. Many of you will recognize this as the diversification standard imposed by the Investment Company Act of 1940 upon investment companies wishing to hold themselves out as "diversified", and also by the Internal Revenue Code for investment companies that wish to be taxed as "regulated investment companies". There is one difference, of course, in that the Investment Company Act imposes this requirement only with respect to 75 percent of the total assets of a fund and the Internal Revenue Code only with respect to 50 percent. Senator Bentsen's bill would apply across the board.

His bill also includes a provision exempting up to 1 percent of the pension funds' assets from the prudent man rule, to permit their investment in the securities of smaller issuers. This is stated to be for the purpose

of encouraging pension fund money managers to invest in small companies, particularly to invest in underwritten offerings of new equities.

We have not been asked to testify or comment upon this bill to date, nor has the Commission attempted to develop an official position with respect to these provisions. Speaking only for myself, as I indicated earlier, I am not opposed in principle to some legal restrictions or requirements with respect to the composition of pension fund portfolios, but I have some skepticism as to whether Senator Bentsen's bill will have a very significant effect upon the market. Most corporate trust officers who testified last summer indicated that in their own departments they had a working rule of thumb of 5 percent anyhow, and the bill would not only grandfather existing portfolios, but exempt disproportions that came about through changes in market values. Furthermore, of course, 5 percent can be quite enough stock in a large listed company so that its sale may be cumbersome and, if not done wisely, have an adverse affect upon the market price generally of the stock.

This does not necessarily mean the bill is bad. The provision, as stated, which applies to an aggregate of all pension funds under a common management, does not completely avoid the problems of proration that seemed so severe when it was suggested that such a provision might apply to all trust assets managed by a bank. But there will be problems among the separate pension funds in allocating the limitation. Nevertheless, it is entirely possible that we would conclude, on balance, that this bill is wise legislation as far as it goes.

There are other subtler problems of the influence and effect of institutional trading upon our securities markets. I think the attitude is generally being accepted that, inasmuch as healthy capital markets are important to the welfare of institutions, it is in the institution's interest not only that there be many individuals trading directly in the market, but also that the broker-dealer industry remain healthy and vigorous. If this is true, then it is not in the institutional investor's interest to bargain the broker-dealer into working for nothing, or for less than a fair return, even if the institutional investor has the

muscle to do so. It must seem ironic to many that the SEC, which spent so much time in the late 1960's berating the management companies of mutual funds for paying unnecessarily high commissions, now is saying institutional investors ought to be willing to pay commissions that are not always the lowest obtainable. Nevertheless, that is our current opinion and the problem is an especially knotty and frustrating one.

In part, no doubt, as a result of our own efforts, counsel are advising money managers that they are living dangerously and face possible litigation of a class suit nature if they pay anything more than the lowest obtainable commission. To date this has not been exactly disastrous for the securities industry, applying as it does only to commissions on trades over $300,000. But, in looking forward to the world of unfixed commissions, one of the real horrors that broker-dealers are pressing upon us is the prospect of being bargained down to an unprofitable rate by their institutional customers.

With this in mind, Congressman Moss, in H.R. 5050, included a provision to the effect that it would not be a violation of fiduciary duty for an institutional money manager to pay a higher commission than otherwise

obtainable as a reward for research. We have supported the idea, but we have expressed some difficulty with the language used. We are afraid of the negative implication that research is the only thing that one can pay more than the minimum for, and we also worry about the suggestion in the bill, as drafted, that the higher commission must always be a specified reward for a particular piece of research made available in the past.

But it isn't, of course, just a question of the proper phrasing of the statutory provision. We are also faced with the practical reality that any given trading desk may well be told, or figure out for itself, that keeping commissions as low as possible is the way to stay out of trouble. Even if, as a matter of legal principle, one can defend higher commissions for other services, including research, they may always seem to be difficult to prove if challenged either in court or by one's supervisor.

There is the further question that, if higher commissions are voluntarily paid to reward research, who should bear the expense, the money manager or the beneficiaries of the fund being managed. We are still struggling for a solution to this. I know that it will not go very

far for me simply to urge portfolio managers to be generous to broker-dealers, even at the risk of being sued. And yet, I think our move toward the unfixed commission era may take a most unfortunate turn if the effect is to cause a sharp reduction in all commissions paid by institutions, because of their presumed greater sophistication and bargaining power, especially in contrast to the commissions imposed upon and paid by individual investors. This problem is still looking for a solution.

There is a broader question hanging over the market of the future with respect to more direct participation in the securities markets by institutions of various categories. Most of you, I believe, have some familiarity with the controversy that has arisen over so-called institutional membership to stock exchanges or institutional access to them. After a long hearing and much deliberation, the Commission came to the conclusion that membership on registered stock exchanges should be limited to those firms that were doing an active public securities business, and should not be used solely for the purpose of recapturing or reducing commission expense.

To that end, we adopted, in Rule 19b-2, a so-called 80-20 provision, namely, that a member must have at least 80 percent of its commission revenues from public business, as defined.

There are other detailed problems in this that I won't explore at this time, and the whole rule is presently in the courts on a challenge, among other things, to the method by which we adopted it. Of more significance, I think, for our present purpose, is the fact that the Commission rejected the so-called "parent" test that previously had been included in the New York Stock Exchange's membership rule. That is to say, under our rule qualification for a membership will be based upon the business done and not upon who owns the firm. Therefore, a subsidiary of an institutional investor, as such, is not forbidden to become an exchange member, nor is an institution forbidden from making a substantial investment in an existing member firm. It is only prohibited from doing these things when its purpose is limited to the conduct of a private business with its own portfolios rather than with the public's.

This view was adopted in large part in recognition of the severe capital needs of the broker-dealer and investment banking industry. The industry, as is well known, is in

critical need of new capital both to sustain its broker-dealer functions, and even more to support its investment banking or underwriting operations. The enormous capital demands of basic industries, including, most notably, those engaged in various forms of energy, have been estimated in the hundreds of billions of dollars for the coming decade, and there is genuine and well-grounded concern in many thoughtful quarters about the erosion of the capital available for the efficient underwriting of this amount of equity securities.

The story is a familiar and sad one. The private fortunes of earlier days have largely left the industry. Then firms turned to the public as a source of capital and for a brief period this looked like the great solution. Today, of course, with the present state of the market for the shares of those broker-dealer firms that have gone public, one can no longer realistically expect additional public offerings to be a source of capital. At least, they cannot be a source of capital until these firms have established a more stable and promising earnings base and market attitudes change. Where else can one turn for significant sums of money for this sort of purpose? One place, obviously, is to

institutional investors. Large insurance companies, pension funds and other institutional investors have the money available for this kind of investment, if it can be made attractive to them. Among other things, more capital is needed for the efficient handling of block transactions by specialists or third market makers, and this has led some persons to conclude that the institutional investor, in a sense, has a duty to put up the funds which will make more liquid its own portfolio.

Whether this can be done and how it can be done, I am not yet prepared to say. It is obviously fraught with dangers and difficulties. It is no secret that the securities industry today greatly fears the intrusion of our major banks into its business. And in addition to this fear, there are also the policies of the bank regulators and antitrust sort of fears about concentration of economic power if one contemplates broker-dealer firms becoming subsidiaries of one-bank holding companies.

I get weary occasionally of giving speeches outlining problems without offering solutions, but I cannot at this moment pretend to see clearly the answers to the questions I

have been discussing. The only message I really have to leave with you this afternoon is the one with which I began. The welfare of the institutional investor, or more properly speaking, the financial welfare of the persons whose savings are invested by the institutions, is of critical economic and social concern. I say social concern, because some have observed that the one calamity our society could not stand would be any significant failure of our pension funds to meet their obligations. But the welfare of institutional investors at large is dependent upon healthy capital markets, and in order to keep our capital markets healthy, institutional investors may have to do their share.

As one man put it recently, the institutional investor is part of the problem and he must become part of the solution. Having recognized the problem, it remains for us to continue the search for solutions with goodwill and not in an antagonistic or punitive frame of mind. We at the SEC, at least, do not seek to punish institutional investors. We hope to further your welfare, and that of the persons for whom you hold funds in trust, by measures which will restore and retain our capital markets in the healthy condition that we so very much need.