REMARKS OF RICHARD B. SMITH, COMMISSIONER,
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BEFORE THE EXCHEQUER CLUB, SHERATON CARLTON HOTEL,
WASHINGTON, D. C., JANUARY 15, 1969
"The Institutional Investor Study"

I understand from Gordon Calvert that you would like to hear something of the background and structure of the study which the SEC is planning to conduct on institutional investors and their impact on the securities market. I am very pleased to be asked to speak to you about this subject. It is one in which my agency and I are vitally interested. Needless to say, I speak for myself and not necessarily for my colleagues or the staff.

I know that your time at these luncheons is limited, and so I shall attempt to keep my prepared remarks as brief as possible so that there will be an opportunity for some discussion later if you like. Because of what I understand to be the nature of the membership of this club, I would hope to profit from such a discussion more than you. But I understand if you must hurry to get back to your desks.

Let me first speak to some of the developments in the securities markets which have created the subject and given it such overwhelming importance. I shall then briefly tell you something of what I know of the considerations that led to the law authorizing and directing the Commission to conduct the institutional study. The law was signed on last July 29th. I will also try to indicate something of the contemplated organization of the study.

A.

In the last 15 years, 20 at most, institutional participation in the ownership and trading in securities -- I emphasize both ownership and trading -- has grown enormously. The initially gradual and then increasing pace of institutionalization in the securities market is clearly the most important development in the securities markets during this period.

Just to give you some sense of the enormity of this growth:

As recently as the end of 1957, private non-insured pension funds, the bulk

bank-administered, held approximately $7.5 billion in equity securities; in June 1968 they held $54 billion.

Mutual funds at the end of 1957 held a little less than $8 billion in equity securities; at the end of June 1968 they held approximately $46 billion.

Insurance companies (both life and casualty) held approximately $8.5 billion in equities at the end of 1957 and by June 1968, despite state laws limiting their ownership of equities, they had grown to about $25.5 billion.

Foundations and endowment funds held approximately $7.5 billion in equities at the end of 1957; by the end of June 1968 they held about $23.5 billion.

Personal trust funds, principally bank-administered, have grown from about $28 billion to about $82.5 billion in the same period.

Some of this growth is undoubtedly due to general appreciation in the value of stocks outstanding, which increased from about $285 billion at the end of 1957 to about $730 billion at the end of June 1968, but this is only about a 2-1/2 times increase. Pension funds increased about seven-fold, mutual funds six-fold, and the rest more than tripled. And the pace is accelerating -- insurance companies, for instance, are now moving into the sale of variable annuities and mutual funds in a big way. That is potentially an additional 200,000 institutional securities salesmen; already there are about 20,000 life insurance salesmen registered or in the process of being registered as securities salesmen.

Very rough calculations -- and this is one of the basic objectives of the study, to develop more accurate and complete quantification, and a system for continued reporting of significant statistics -- very rough calculations would indicate that today about one-third of the ownership of equities is in the hands of financial institutions.

For a number of years now, individuals have been net sellers and institutions net buyers of equity securities. At the same time that this has been occurring, there has been a near elimination of new common stock issues from the financial programs of large American industrial companies. Another of the basic objectives of the study will be to give consideration to this apparently growing imbalance between institutionally created savings and appetites for equities, and the available supply of portfolio securities.

At the same time that institutional ownership has been increasing, it is apparent that institutional trading has been increasing even more -- at least in the last several years. It has been, again, roughly estimated that about 50% of the trading on the New York Stock Exchange is now done by institutions of various kinds.

The growing strength of the institutions, of course, is due to a number of developments. Many institutions, out of concern for inflation and for improving their comparative performance, have shifted from debt securities of various kinds, including mortgages, to investment in equities. Collective bargaining, and governmental as well as union and employer concern for treatment of those retired from our working population, have vastly increased the pay-ins to pension funds. State laws limiting fiduciary investment have been liberalized in recent years throughout the country. Because of the increasing complexity in making investment decisions in our technological economy -- some call it post-industrial -- many individuals prefer to leave their investment decisions in the hands of professional investment managers. And, of course, mutual funds have not lacked in their ability to provide financial incentives to those who herald the desirability of collective investment and wish to satisfy the demand for it.

So the causes of institutional growth appear to be many and varied. I am sure there are a number of factors I have not averted to. To inquire further into causes so as to understand them better is another aspect of the study.

The result in the marketplace from institutional investment has been a happy one in the sense that the massive demand has increased the general price level of equity securities substantially, but it also has produced some troublesome, or potentially troublesome, features.

Institutions are competing more aggressively with each other and competition often is in terms of performance. Some have felt this to mean short-term performance. The resulting increased trading has contributed materially to keeping the securities markets boiling. The real significance or impact of large pools of capital engaged in trading operations remains to be seen. Go-go funds, some with capital in the area of $100 million, use highly speculative techniques including margins, puts, calls, short selling, all with very quick time horizons. The effect on fair and orderly markets and on their own interestholders, which funds with high turnover ratios have, is a subject that will require the attention of the study.

As savings are collectivized (if you will forgive the word) into large funds, the number of investment decision makers diminishes. And, since many of the large investment managers have equivalent access to information and expert analysis -- or should have, that is another timely subject not unrelated to institutionalization -- it is possible that investment decision making will become, or is becoming, more homogeneous and simultaneous. What the full effect of this can be upon the market also remains to be seen. There are some, of course, who believe that institutions will protect themselves against this kind of a development by delegating investment management decisions to sub-units. Whether this will occur, and whether it will have a counter-effect, also remains to be seen.

The purchase or sale by one or more large institutions of a security of a company with a relatively small public float can dramatically and abruptly move the price of that security. While the proportion of individual investors in the markets is diminishing, they are still numerous, and in absolute numbers have grown. What effect such large movements of capital into or out of particular securities has on the smaller individual investors who have been schooled to look for a "fair and orderly market" is also a question of some moment.

But the questions go beyond the impact on securities prices. The growing orientation towards equity securities means that the savings have been diverted from some other channel such as investment in land, mortgages, insurance, government

bonds, industrial debentures, savings accounts and so forth. The resultant reallocation of the nation's capital resources, and its effects, require better understanding.

The impact of institutional investors has perhaps been heaviest on the organized securities auction markets, primarily the New York Stock Exchange. The enormous economic leverage which the institutions brought to bear on brokers enabled them partially to break down the exchange commission structure which had prevailed for some 60 years or more. By this time I am sure most of you are familiar with the now-banned practice of give-ups that had developed in the securities industry.

The pressure of the institutions on the use of commission dollars and on the level of commission rates for their large orders has also been accompanied by the efforts of some institutions to become direct members of the exchanges themselves. This, of course, would work a radical transformation of the organization of the securities markets as we know them. While these are matters which the Commission is dealing with in a separate pending investigatory hearing devoted to commission rate structure problems, there is an obvious spill-over into the matters which the institutional study will be delving into.

The spill-over is also evident in the variations which institutional investment has placed on the exchange specialist system. The specialist system had been developed on the national securities exchanges to service the relatively large flow of relatively small public orders concentrated at the point of trade on the floor of the exchange. The specialist is there to buy or sell for his own account to meet any random imbalance of purchase and sale orders. His general obligation is to maintain a fair and orderly market. However, when large institutional blocks appear for purchase or sale, the specialist has generally not been in a position to handle orders of such magnitude. Special techniques have been developed by exchange member firms to deal with this, such as block positioning, floor crosses and special exchange distributions.

In addition, a so-called third market has developed (in fact, it preceded, and perhaps led to, the appearance of the member block positioners). Third-market makers are heavily

capitalized firms who are not members of any securities exchange and who buy and sell listed securities off the floor of the exchange for their own account. It has been estimated that their position taking capability aggregates something like $100 million. These third-market makers aggressively attack exchange rules designed to keep trading on the floor.

There is another impact which institutionalization has produced which is indirect as to the markets but direct as to the corporate issuers of securities. That is the relationship between corporate managements and the institutional investors who act as financial intermediaries to their ultimate share-holders or pension holders or policy holders or whatever. Should institutions be passive investors, in the sense that if they are dissatisfied with management they will simply sell securities or not buy securities of that particular issuer? If the role is to be passive, that leaves corporate managements in a stronger position vis-a-vis the diminishing proportion of individual investors and because of the increasing size of the positions being taken by the large institutions, it may not be a simple decision simply to dispose of a large holding. On the other hand, if institutional investors are to be active shareholders and attempt to influence or control corporate managements, this raises the age-old dispute as between financial and management control of the American industrial system. The role of institutions in certain take-over bids has already posed these questions. This may well be another area upon which the institutional study will have to reflect.

B.

The pressures of institutionalization have thus been great. I have indicated only some of them. They led Congressmen Hastings Keith and John Moss to introduce a resolution in the Congress in early December 1967 directing the SEC to make a study and investigation of the purchase, sale and holding of securities by institutional investors of all types.

At the time of the introduction of this resolution there was some thought expressed that this study was to be the House alternative to the-then pending mutual fund legisla-tion which was bitterly contested in both houses of Congress.

However, I think everyone soon agreed that a study of institutional investors and their impact on the securities markets went far beyond and beneath the matters dealt with in the mutual fund bill. The Commission embraced the idea, as eventually did the entire industry.

At one point a number of people in the industry felt that such a study should be conducted not by the SEC but by a new, specially created independent commission. In the end, however, I believe all became persuaded that it would be most beneficial both to the securities industry and to the Commission to have us conduct the study. Most people felt that the kind of instruction and knowledge that would be gained through such a study could most beneficially be utilized by the agency that was charged with continuing jurisdiction over the securities markets and a major element in its markets, the investment companies.

One concern that some people in the industry expressed was that if the Commission conducted the study, it might end up as a lawyer's investigation to serve some regulatory objective. The concern on that score was effectively dealt with, first, by the clearly expressed determination of the Commission that this would be an economic, analytical study with no axe to grind. Secondly, by the statutory creation of an Advisory Committee for the study to be established by the Commission in which there will be representatives of both financial institutions and those engaged in operating the securities markets. The Advisory Committee has not yet been named, but the Commission has had an initial meeting with representaitves of the major institutional organizations and market organizations at which suggestions for such an Advisory Committee and the role it is to play were discussed.

The Congress authorized a maximum of $875,000 for the study. In October $300,000 was appropriated. The study staff, which will be separate from the rest of the Commission's staff, is now in the process of being organized. Its director will be Donald Farrar, Professor of Finance at Columbia, who was formerly at MIT and who received his economic training at Harvard. The associate director of the study has been selected and he will be Seymour Smidt, who is an economics professor at Cornell.

The study will have a staff of approximately eight economists, four lawyers and assorted support personnel, including statisticians, analysts and programmers. It will draw heavily on existing resources in industry, the financial community, other government agencies and the universities.

While the act authorizing the study provided for the Commission to report back to the Congress by September 1969, that will not be feasible. We plan to ask the Congress for an extension of time, perhaps a year or so.

I think I should stop here and let you go. I'll be glad, of course, to talk further with any who may want, and are able, to stay. In any case, I thank you for letting me join you today.