An Address By

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I thought that I would come here and enjoy relative peace and quite, but your program has forcefully reminded me that banks are not the bastions of conversatism and unchanging tradition that they once were. The great winds of change that have affected society in general have obviously had their impact on banks -- and bankers.

Revolutions are all around us -- on campus, in the cities, in science and technology and, of course, in business and the corporate world. Our world is changing and we must strive to keep up. No one is surprised today when bankers talk of portfolio performance, going into the mutual fund business, and diversification.

Just as bankers are broadening their horizons in financial and non-financial fields, it is clear that others are covetously eyeing the banks. In recent days we have had further evidence that banks are not immune from take-over bids. Now this may have come as a bigger shock to some of you than to me -- but it all goes with the steady erosion of the public image of business, financial and non-financial institutions. Banks in particular looked to so many of us as medeival and unpregnable castles -- like the bank in "Mary Poppins" -- thruppence prudently invested was the foundation of empires!

There is no doubt that the securities business -- like the banking business -- is faced with changes of revolutionary proportions. In the scheme of things that "revolution" may not equal in dramatic quality the events on campus or in outer space -- but we should not judge the significance of events by their T.V. ratings. You as bankers represent one of the most important segments of the institutional picture and I believe that you have a special concern with the phenomena which are now taking place in our securities markets.

I need not emphasize to this audience that the securities markets are vital to the functioning of our entire economy and their continued well being is the business not only of the brokers and the exchanges, but of those who trade in those markets -- especially those who act on behalf of the public -- the banks, the investment companies, insurance companies and other institutions. That developments in the securities markets are also matters of great public concern is also reflected by the broad scope of our responsibilities under the federal securities laws.

Our mandate is to maintain fair markets and to regulate those markets in the public interest and in the interests of investors. These are broad goals and there is much law -- and lore -- to give meaning to these Congressional directives. The breadth of the public interest is reflected not only by 24 million shareholders, but by the additional millions who invest in the markets indirectly through institutions, by those who come to the market to raise capital for their businesses, and by those in the financial world whose business it is to serve these various interests.

There is little doubt that in recent years the banks have quickened and expanded their interest in equities and equity investment media to fulfill their traditional fiduciary responsibilities and to expand the range of their "services" to larger groups of their customers -- in short -- to attract more business. The banks, all kinds, commercial and savings institutions, like the insurance companies, have not been unaware of the potential offered by equity investment media and their appeal to the public. Of course, the relative increase in individual savings, which have been moving to equity oriented vehicles has stimulated this change in attitude and interest.

The progression of cases on the insurance side of the fence (VALIC, Prudential and most recently United Benefit), which have eliminated any question of the application of the federal securities laws to the vehicles in these cases of insurance company sponsored investment companies, is clearly applicable to bank sponsored entities -- as we made clear in our FNCB opinion and as we had more informally indicated some years earlier.

I am not here to comment on pending cases -- or to discuss the nature or applicability of the restraints of the Banking Act -- but it is important to point out that these securities market developments are of real and immediate concern to banks and bankers. The traditional trust and pension advisory business of the banks is more than enough to make you much more than mere casual bystanders. You may, therefore, have more than a passing interest in the great changes now taking place in the securities markets.

There are several lines of development which we have been watching -- and I am sure you have been watching -- with great interest. These include institutionalization, conglomeration, speculation, back-office problems and other phenomena of our corporate and business lives.

We tend to use slogans these days to describe the great changes occurring around us every day. But, the trouble with slogans is that they tend to be a substitute for, or an excuse for failure to engage in, careful analysis. They also fail to convey the same ideas to all people. And the changes going on in our transitional society are complex and difficult and important enough to merit the most careful analysis and understanding.

You are all aware of the rapid development, for instance, in the past few years towards "institutionalization of our securities markets." This means, simply, that more and more of the outstanding equity is being acquired by financial intermediaries and that more and more of the activity in our markets is a reflection of quickening activity by those institutions and those who would imitate them. A brief sketch of the dimensions of this trend may be helpful.

Institutions owned about $260 billion in equities (34% of that outstanding in 1968 -- up from $66 billion in 1954 -- then 25% of outstanding equities). Bank trust accounts alone accounted for an incredible $163 billion in stock in 1968. The stock assets of the five largest banks exceeded the stock assets of all open-end investment companies put together.

Institutionalization has been truly startling, not only in its scope but also in its velocity. For instance, the net assets in the mutual fund industry now stand at over $52 billion, almost $10 billion more than a year earlier. The entrance of the insurance companies into the fund field, a development which has not gone unnoticed by your industry, adds an additional sales force potential of 200,000 (with access to an estimated 130,000,000 life insurance policyholders) to the 50,000 salesmen and brokerage representatives now selling fund shares. Five million Americans now own mutual fund shares -- a figure which is likely to double, at the least, in the next five years, (by which time, at the present rate of growth, the industry should reach $100 billion in assets).

Institutional activity in the stock markets during the third quarter of 1968 (the latest for which we have complete figures) is fairly indicative of the times.

The dollar value of transactions in common stock by four principal categories of institutions (private non-insured pension plans, mutual funds, life insurance companies and fire and casualty companies) totaled $16.8 billion or 36% higher than the same period in 1967.

Mutual funds alone accounted for over half the transactions with total third quarter transactions of $9.5 billion. That third quarter 1968 figure for mutual funds alone exceeds the total of all institutional transactions for the entire year of 1965 ($9.2 billion) and is not very far from the total 1966 figure ($11 billion) for all institutions.

The turnover rate, during the third quarter of 1968, for the New York Stock Exchange was 20% -- for the institutional group as a whole 25%, for open-end funds 45%! This compares with 20% for the institutional group and 38% for the funds during the same quarter in 1967. Please note that the turnover rate for life insurance companies doubled (from 12.5% to 24.5%) from the third quarter 1967 to the same quarter in 1968. 1/ Institutional share volume on the New York Stock Exchange grew from 24% in 1966 to 33% in 1968. But from 1966 to the third quarter of 1968 it appears that the institutional share of total volume has expanded sharply and is now near 50%.

1/ SEC Statistical Release No. 2331, Dec. 19, 1968.
SEC Statistical Bulletin, January, 1969 pp. 22-23.

You may also be interested to note that total assets (market value) of private non-insured pension funds amounted to $82 billion at the end of 1967, up $11.7 billion from 1966. More important is the fact that $48.5 billion was in common stock, $10.7 billion more than 1966.

These are rather impressive figures -- figures which merely stress what most of you already know. They show (1) that institutions are growing and apparently will continue to grow at a pace unforseen just a few years ago; (2) that turnover and volume are exceeding all predicitions; (3) that traditional notions of money management are being tested by strategies which accentuate volume, turnover and many other trading and speculative techniques which feed the other market problems I have mentioned; and (4) that we know only in a vague way what all this means and where we are going -- how this relates to other economic phenomena and what kinds of policy (economic and regulatory) are required to cope successfully with these changes.

We hope that our recently launched Institutional Investment Study will find the answers to these and other problems posed by this "institutionalization." We have selected a distinguished Advisory Committee and the Study is now fully underway. We hope that this Study will place the activities of institutional institutional investors in perspective and provide a factual basis for the policy and regulatory recommendations we must make to the Congress. We believe, first, that the problems and the issues must be clearly defined or identified. This will be no small task. I am hopeful, however, that, at the least, the Study will, in the end, describe the institutions more clearly, determine whether problems exist or are on the horizon, and provide meaningful answers for the issues posed.

There are a number of aspects of "institutionalization" which deserve further comment and may help to indicate the scope of our concerns.

"Institutionalization" of savings will direct more and more of public savings into professionally managed vehicles which place greater emphasis on equity investment. It will be important to prove or disprove the contentions that investment decisions by the advisers to such pools of capital tend to become more homogeneous largely because they reflect the decisions of a relatively few money managers trained in similar techniques and constantly peering over the shoulders of their colleagues and competitors. If a trend to parallel decision making develops, investment managers will be faced with the possibility that their decisions will cause even larger swings in the market and more pronounced reactions to investment decisions, especially where markets are thin, because of the slower growth of available equities or their more rapid absorption by the institutions. This problem is made more urgent by the fact that stock exchanges were designed as central meeting places where relatively small buy and sell orders of individual investors could be matched -- not the tens or hundreds of thousand share blocks which are becoming the commonplace trading institutions. The specialist, was developed to provide liquidity and correct temporary imbalances in the supply and demand for particular stocks, and no longer can, alone, meet the large needs of the institutions.

The flow of blocks has more than quintupled since 1964. (There were well over 1,000 such transactions in October 1968 alone.)1/ These developments have already led to, and undoubtedly will require additional, new techniques to deal with potential market imbalances. It is obvious that these developments pose severe problems in the maintenance of orderly markets.

Mechanical problems may be susceptible to solution, given adequate attention and imagination. But more important policy issues are raised.

The reluctance, at least until recently, by the persons engaged and the institutions involved in the securities business to extend the privileges of exchange membership to others, when coupled with effective limitations upon normal competitive forces, have given rise to an acute issue of substantial significance and one which threatens to split the securities industry along bitter and controversial lines. The issue is usually, albeit somewhat inaccurately, referred to as institutional membership on exchanges.

1/ See table p. 72 Institutional Investor, Dec. 1968.

The significance and the difficulty of these issues is reflected in the interest of, and strong positions taken by, the Anti-trust Division of the Department of Justice. Related issues concern public ownership of member firms, economic access to the exchange on a preferred basis by all persons engaged in the securities business no matter what the nature of their ownership, and, conversely realistic access by exchange members to competing markets for listed securities elsewhere. The development of "the give-up" and other esoteric techniques to provide for a sharing in the fixed and excessive commissions generated by larger institutional transactions kept the fixed minimum commission rate theoretically intact, but cast considerable doubt on the appropriateness of rate levels. The abolition of give-ups -- frankly described by industry leaders as a step to preserve a fixed commission schedule -- and the new interim rate have not abated the pressure for "institutional membership". There is no question as to the importance of this issue for the markets, the securities industry, and for investors, large and small. The development of the Third and Fourth Markets, volume discounts and the increased use of the regional stock exchanges by financial intermediaries -- those which support real equity markets and those which, at least in the past, served essentially and in the main as funnels for the distribution of brokerage commissions -- require careful analysis and evaluation. These issues, which are linked in many respects, have been, or are being developed in our current commission rate structure hearings. Many are affected, and even spawned, by institutional trading. Certain of these issues, particularly those which have implications beyond the commission structure, will be evaluated by the Institutional Study. I would emphasize, however, that this does not mean that we will wait until the Study is completed to deal with the urgent commission rate problems now before the Commission. These must and will be dealt with as promptly as possible.

Increased participation by institutions in the equity markets will also affect the allocation of public savings and the extent to which such savings flow to the various competing media. Traditional distinctions among financial intermediaries are rapidly disappearing as the supermarket approach is adopted by many institutional investors. Banks, insurance companies, and others have begun to form multi-faceted financial organizations, financial conglomerates, to offer various services including equity based vehicles -- both traditional and novel -- to the public. In plain language -- the insurance companies are in the mutual fund business and the banks are testing the water. The distribution processes for such equity oriented products do not always follow the traditional channels used in the securities business. They involve new merchandising techniques which require assessment and response by the regulators, state and federal, and by those now engaged in these activities.

The trend to institutionalization has bred or contributed to other problems. Thus, a whole array of serious issues are referred to as "the back-office problem" -- not all of which, I hasten to add, can be blamed on the securities industry.

In the past, institutional investors -- mutual funds, bank trust departments, pension funds and others -- tended to be more conservative -- investing for the long term. In the past few years, however, the "cult of performance" has emerged and attention has been focused on those with the "best track records" in the previous year -- or even six months. More of these institutions, particularly certain mutual funds, have become short-term traders who act not only with speed but in volume. This emphasis on short term performance, has fed the fires of volume. It is not unusual for the so-called performance funds (or merely very aggressive common stock funds) to exceed 100% turnover rates in less than a year. Some of the activity generated by these funds is highly speculative.

This institutional activity has coincided with a great rise in direct public participation in the markets and a willingness, if not a desire, of a more affluent public to speculate or to hedge against the most frequently referred to phenomena -- inflation.

I need not dwell at any length on the vast increase in volume of trading. Twelve million share days are now described as "light to moderate" trading. Despite the fact that the exchanges were closed one day a week during the latter part of 1968, the volume on the New York Stock Exchange was 60-65 million shares a week. It averaged more than 13 million shares a day and on occasion topped 20 million. The American Stock Exchange volume, which during the last week in January seemed almost ready to catch up with NYSE volume, now climbs to around 6-7 million shares a day with some regularity. (The Vancouver Stock Exchange reached 6 million shares recently). You do not have to be an oldtimer to be amazed by these figures. This high volume is perhaps the most visible symptom of the changes I have been describing.

We have learned by now not to underestimate the gravity of these "mechanical problems." They can be every bit as serious, challenging and demanding of statesmanship as the most complex regulatory problems. Let me note here that the paperwork or back-office problem is, like the others, not only the responsibility of the brokers and the exchanges; banks which act as transfer agents or registars and do other bookkeeping and ministerial work for corporations and institutional investors have a clear responsibility to their clients and to the public -- a responsibility which has not always been recognized or fulfilled. This paperwork glut can have very serious consequences for the public. I am advised that transfer agents are now fully aware of the gravity of this problem -- a problem which will become more difficult as we enter the annual meeting season, and face the volume of proxy material that engenders.

Other problems are developing from the growing emphasis on "instant performance." One of these problems concerns the methods used in valuing, and the validity of the values assigned to, assets held by funds -- assets with significant restrictions on ready liquidation. We have already witnessed the difficulties faced by one fund and its investors caught first by inadequate internal procedures and by the collapse in value of one such portfolio security. Apart from the losses which may be suffered by individual investors, and the damage to the image of other funds, this case provides some clues as to the thinness of the ice on which some are skating.

Another problem which is viewed with considerable concern relates to the concentration of economic and financial power being gathered in a relatively few hands by rapidly growing institutions. The relationships between the managers of the institutions and the managers of portfolio companies is of growing concern to our legislators and to our industrial, business and financial communities.

Another aspect of the revolution I have been discussing is the accelerating trend towards "conglomeration" -- another slogan word. By any standard, merger and take-over activity has been one of the most important developments of recent years. A Presidential Cabinet Committee on Price Stability reported recently that the economy is undergoing "a massive restructuring from conglomerate merger activity."

The take-over movement has grown to the point where giant companies are threatened by small companies which issue paper -- sometimes cynically referred to as "funny paper" -- as the incentive for the take-over. Others have described it as "monoply money." I recall now that, when the Williams Bill was proposed, predictions were made that tender offers would dry up. Well, that prediction, like nearly every prediction concerning securities legislation is in the same class as the prediction that the Investment Company Act of 1940 would kill the fund industry and the earlier predictions in 1933 and 1934 that the securities industry would disappear.

I would remind you that it is not our role to inhibit tender offers. It is our job, under the Williams Bill, to make certain that bidders, and management, meet reasonable disclosure standards so that the securities issued in, and other aspects of proposed take-overs, can be evaluated properly by security holders. We have promulgated temporary rules under the Williams Bill -- and will shortly publish proposed longer term rules.

We have also proposed improvements in disclosure to security holders of widely diversified companies which would require management to break down corporate revenues and earnings on a more meaningful basis. This should be of assistance to security holders and their advisers in assessing the past experience and future prospects of these companies by providing useful information regarding the disparate businesses typical of conglomerates.

The merger and conglomeration movements are receiving the concerned attention of our national legislators. Congressman Hastings Keith of Massachusetts has introduced a resolution authorizing an inter-agency study of the effects of conglomeration. Other agencies or departments of government are conducting studies. Our own Institutional Study will deal with some of the questions. But this is not a phenomenon which can be consigned to study groups and forgotten for a few years. Events are moving too swiftly. We are witnessing a form of aggressive mid-20th Century corporate warfare and the stakes are very high. The lawyers are busy devising strategies -- both defensive and offensive -- but no strategy will eliminate the trend. The questions are not easy and involve a host of national policies from those reflected in the securities laws to those embedded in the anti-trust laws.

The banks have not been sitting on the sidelines. In addition to providing some of the largest targets for take-over (in the same class with some of the insurance companies), and the funds needed by bidders, they have also participated in the conglomeration trend. One bank holding companies, "phantom banks" and congenerics have entered the vocabulary. I understand that more than 60 of the country's largest banks have formed or are in the process of forming one-bank holding companies. This morning's newspapers carried news of a massive report issued by a Committee of the Congress. The "banking revolution" has swept the industry in record time. The practical effect of all this is that banks are entering allied -- and, in view of some, unallied -- fields.

Conglomeration or, at the least, congeneration in various areas of the business community, seems to be here to stay. The policy questions raised, including the issues of concentration of economic and financial power, the issuance of vast amounts of new types of securities for old fashioned common stock, and the industry and corporate structural shifts, pose for us, for the banking authorities, the anti-trust division, legislators, and others, extraordinary problems which we must analyze and solve.

I have discussed some of the problem areas with which we as regulators and you as businessmen must deal. Each area offers a substantial challenge to the genius and imagination of industry and government.

I believe that we can meet the challenge of rapidly changing markets, institutionalization, greater public participation, choked trading facilities, speculative activity, conglomeration and the other problems before us by cooperative and intelligent effort, and by imaginative and sympathetic but determined approaches on the part of government, the self-regulatory agencies and the industries involved.