HOLD FOR DELIVERY

Address By

THE HONORABLE MANUEL F. COHEN

Chairman, United States Securities and Exchange Commission

Before The

American Management Association

New York, New York - November 16, 1966

Emerson described an institution as "the lengthened shadow of one man." The men who manage the large investment institutions today cast long shadows indeed -- shadows which have fallen on all of the major areas of regulation with which the Securities and Exchange Commission is involved.

The essence of institutionalization is the development of new and more complex relationships. The relationships with which the Commission is concerned, and which I should like to discuss with you this morning, fall into three major categories. These are the relationships of the institutional managers to the beneficiaries for whom they act, to the markets in which they trade, and to the companies in which they invest.

The institutional investor is not a new phenomenon; it has been with us for a long time. What is new is the use of institutions as a medium for channeling the investments of a multitude of small investors into the market for equity securities. The two major prototypes of this development are the investment companies and the non-insured pension funds. During the ten years ending in 1965, the stock holdings of the investment companies increased from twelve billion to forty-one billion dollars, and those of the non-insured pension funds increased from six billion to forty billion dollars. What is more, all of the statistics available to us indicate that the very rapid flow of savings into equity-oriented institutions will continue in the future. Recent projections of private pension fund assets, for example, point to a doubling in this segment alone within the next decade.

The number of individuals who own shares listed on the New York Stock Exchange rose from about seven million in 1956 to twelve-and-a-half million in 1965. However, the relative importance of individuals as direct investors in the equity markets was decreasing during the decade while their indirect participation in that market through the medium of institutions was increasing. This has posed a tremendous challenge to those of us who are charged with responsibility for maintaining the health and vitality of the securities markets. The standards and procedures developed over the past 30 years to deal with the more or less direct relationships of issuers to individual investors must be reviewed in the light of these developments and, where appropriate, modified to deal with the changing securities markets and the colossal institutions which stand astride them.

The first relationship I should like to talk about is the relationship of the institutional managers to the beneficiaries for whom they act. As I said, the investment companies and the non-insured pension funds have had the most significant role in recent years in channeling the savings of a multitude of small investors into the market for equity securities. Yet to bracket these two in a single category illustrates the complexity of the problems we face. While their functions may be essentially similar, the regulatory problems which they raise could hardly be more divergent.

The SEC has jurisdiction over mutual funds and other types of investment companies. However, the Investment Company Act, which vests the Commission with certain regulatory responsibility for investment companies, was enacted in 1940, when the total assets of investment companies amounted to only about one billion dollars, as compared with forty-seven billion dollars at the end of 1965. Growth of this magnitude has changed the whole setting in which we examine such things as investment performance and management compensation. We are now completing a comprehensive report which will set forth our recommendations for updating the scheme of regulation to assure that the investors in mutual funds derive appropriate benefits from their chosen medium of investment.

Employee pension funds pose entirely different problems. The manner in which employees become participants in these funds bears little resemblance to standard methods of selling "securities." Yet these employees do become indirect holders in aggregations of capital which are invested and reinvested in equity and other securities, even though many of them may be only vaguely aware of their increasing commitment to the securities markets.

Up to now there has been only limited Federal legislation regulating the investments of private pension plans or laying down guidelines for the conduct of their trustees. In some instances even state regulations governing trust funds do not apply, because the funds are not considered trusts under state law. In these cases, employees covered by the plans may have little or no protection. Ways must be found, consistent with the legitimate interests of all parties involved, to insure that these employees enjoy protections comparable to those enjoyed by other indirect investors.

The life insurance companies, through such media as variable annuities, and the banks, with their commingled trust funds and other investment advisory services, also offer methods for the small investors to participate in the equity markets. While investments in the stock of fire and casualty insurance companies have for many years offered opportunities for portfolio investment comparable to those offered by investment companies, the use of new forms of annuities as a medium for such investment is of much more recent origin. These relatively new techniques have created additional problems for us in applying the provisions of the Investment Company Act to institutions which operate differently from those which we have been accustomed to regulating over the past quarter-century.

To summarize, the present pattern of regulation of the relations between institutional managers and their beneficiaries is marked by a high degree of incompleteness and inconsistency. We hope that our forthcoming report will lead to a more adequate scheme of regulation of investment companies, and that ultimately the beneficiaries of all types of institutional investors will be protected from unwarranted actions by those who are responsible for their funds and will realize the fullest benefits of their participation in managed investment media.

Turning next to the relations of the institutional managers to the markets in which they deal, the problems are, if anything, more complicated and less fully understood than those involved in the relations between managers and beneficiaries. The massive diversion of the accounts of small investors from direct participation to indirect institutional participation is having a profound effect on the securities markets, the full import of which can only be dimly perceived at the present time.

We can, however, identify the principal areas of impact, and we can also begin, and have in fact begun, to take steps which we hope and expect will place the markets in the best possible position to meet the stresses and challenges of these new developments.

As you are well aware, the size and nature of the institutional investors have inevitably led them to channel the great bulk of their equity investments into securities listed on the New York Stock Exchange -- in fact, into the very largest companies listed on that Exchange.

An exchange market for securities is a very complex market. It is not really a market for one commodity, but two -- a market for securities and a market for broker-dealer services. In this latter market for services, competition is limited and practices are regulated in order that the underlying market for securities will be one in which the public can trade with confidence that the prices of particular securities are determined by economic factors relating to the securities themselves undistorted by peculiarities or irregularities in the market for broker-dealer services. The growth of institutional participation in the equity markets has had a significant effect on both of these markets.

The effect on the market for broker-dealer services is perhaps the one that has been most visible in recent years. As you know, the New York Stock Exchange's commission rate structure requires a customer to pay a fixed minimum commission for each 100 shares of a certain security which he buys or sells -- regardless of whether the transaction involves 100 shares or 10,000 shares. However, the economics of the situation are such that the brokers are willing to execute transactions for their important institutional customers at prices which are less than half of the minimum commission rates. Since they are not allowed to give rebates or discounts to the customers directly, a variety of practices has developed, all of which have very serious implications for the health of the securities markets:

-- The broker may be directed simply to "give-up" a portion of his commission -- often 60% or even 70% -- by making direct cash payments to other New York Stock Exchange members who have performed other services for the manager of the institution -- services which may or may not benefit the institution. In the case of mutual funds, the "other service" is usually the sale of shares of the mutual fund itself.

-- The transaction may be executed on one of the regional exchanges where the stock is listed. This permits the customer to direct a "give-up" to a dealer who is not a member of the exchange (the rules of the New York Stock Exchange prohibit "give-ups" to non-members). Or the institution may even share in the commission itself by becoming, through a subsidiary, a member of the exchange (the New York Stock Exchange prohibits such memberships).

-- The transactions may be executed, on a principal basis, with a non-member of the Exchange who trades in listed securities for his own account in the so-called "third market," and is often willing on large transactions to charge a mark-up which is only a small fraction of a New York Stock Exchange commission.

I am simply pointing out the obvious when I tell you that the development of these techniques is having a very important effect, not only on the price structure of the market for services, but on the underlying markets for the securities themselves. I do not think it is appropriate for me to express a view today as to the desirability or propriety of the development of these practices, although we are of course concerned with any method under which the cost savings inherent in institutional transactions are not passed on to the beneficiaries of the institutions. But the existence of these practices helps us, as regulators, not only by pointing out where the problems lie, but also by helping to delineate the range of alternative solutions, and the advantages and disadvantages of each. We are actively working with participants in the securities markets at the present time to develop a rational commission rate structure which takes the special problems of the institutional investor, as well as those of the individual investor, into account, and prevents the rates for services from becoming a factor which distorts or dilutes the market for securities.

Of course, the institutional investor has also had an enormous direct impact on the markets for securities themselves. The concept of the central auction market, with brokers bringing their buy and sell orders to a single "specialist," who matched orders and bought and sold for his own account to maintain continuity in the market, was developed and flourished at a time when the market for the shares of at least the larger companies consisted of a relatively steady flow of 100 share orders placed by individual traders or investors. But when the investments of individuals are channeled into the market through institutions, the decisions to buy and sell particular securities are made by the institutional managers rather than the individual investors. Thus, a hundred different decisions to buy or sell a hundred different securities at a hundred different times become one decision to buy or sell one security either at one time or over a specified period of time. Moreover, the atmosphere in which institutional decisions are made is such that there may be a considerably greater likelihood that different institutions will reach the same decisions about a particular security at a particular time than that different individual investors would do so.

This development has placed strains on the specialist system -- indeed, on the exchange system as a whole. In fact, several instances have been reported to us recently in which institutional selling, done in a manner which exaggerated the market impact of the decision to sell, has triggered rapid movements in the prices of particular securities.

It has been suggested that experience in the bond market -- which obviously differs from the market for stocks in important respects -- indicates that as a market becomes increasingly institutional, the volume of business tends to gravitate from the exchange to an over-the-counter market. In England, where it is estimated that institutions now account for more than half of the volume in stocks, a great deal of institutional business is reportedly effected off the exchange through merchant banks, operating very much like our third market makers. The German securities markets, dominated as they are by the banks, offer additional evidence of this tendency. In both countries, there have been complaints that the dilution of the central exchange market has had a deleterious effect on the quality of the market, with increased risks to the investing public. We must proceed with imagination and energy in this area if we are to preserve the advantages of the exchange system, which has made such an important contribution to the efficient allocation of capital in our economy, while at the same time bringing additional strength to the market to enable it to meet the ever-increasing and sometimes sudden needs of the institutions. I hope that automation will help us in the long run to make important new strides in this area.

We recently took an important first step in dealing with these problems when the New York Stock Exchange, at our urging, amended its rules to permit its members to deal directly with qualified non-member market-makers on a net basis when they have orders which can be executed more favorably outside the regular Exchange mechanism. We plan to exercise special diligence in this area to deal with problems that may arise under the new rules, to determine whether the change is achieving its purpose, and to consider whether modifications or further changes may be required.

The growth of institutional investors, which tend to concentrate their orders among a relatively small number of brokerage firms, has been matched to some extent by the growth of what I might call "institutional dealers." The small dealer simply does not have the facilities or equipment to handle the needs of the large purchaser; the merger activity among securities firms in recent years is in part a reaction to this problem. The small broker-dealer, like the small investor, has in many cases become largely an indirect participant in the securities market; his business is increasingly devoted to selling the mutual fund shares which the small investor buys. This trend has been hastened by the disparity between the gross spread on the sale of mutual fund shares and the commissions on the sale of listed or over-the-counter securities.

Our understanding of the effect of the institutional investors on the level of security prices -- either for particular stocks or for the market in general -- is not as complete as we would wish. There is no question that the institutional concentration on the "blue chip" stocks has an important effect on the prices that large and small companies have to pay when they go to the stock markets to finance their expansion or their new ventures. There is no question that the decisions of institutional managers have an important effect on price movements during prolonged periods of rise or decline in the market. There is no question that the drying-up of "market-making" transactions -- the 100 share transactions that are actually executed on the floor of an exchange -- is having an important effect on the depth and continuity of the market. The only question, in each of these cases, is what the effect is. Until we know more than we do now, we will be handicapped in reaching intelligent judgments about developing situations promptly enough to take effective action in the public interest.

The third area I wanted to talk to you about is one in which I am sure you all have a deep interest -- the relationship of the institutional managers to the companies in which they invest.

The general approach of the federal securities laws to the issuers of publicly-traded securities has not been regulation, but requirements for disclosure. The most important disclosure requirements have been keyed to two basic events -- the offering of additional securities and the annual meeting of stockholders. We also require annual, semi-annual and periodic reports to be filed with us, but I do not believe that the substance or the use of those reports has as yet fulfilled the objectives which the Congress had in mind when it included the reporting provisions of Section 13 in the Securities Exchange Act of 1934. This is a problem to which we are currently devoting our special attention.

To repeat, then, the most important statutory disclosure requirements apply to the offering of additional securities and the annual meeting. Of these two, the requirements applicable to the offering of securities -- embodied in the "1933 Act Prospectus" -- are the more far-reaching and the more seriously regarded. This means that, while the great majority of purchases in the securities markets, by institutional or other investors, are made in the course of secondary trading, the amount of information available about the issuer which was prepared in accordance with the highest standards of the securities laws depends on the fortuitous circumstance of how recently the issuer has made a public offering of additional securities.

This has led some people to suggest that the disclosure provisions of the securities laws, as now being applied, are not producing the quality or amount of information that is essential for informed and undistorted trading in the secondary markets. There is some evidence to support this view. The institutional managers and analysts have recognized this deficiency, and they have attempted to meet it by direct personal contact with the officers of the issuers in which they are interested. Now, I am a leading exponent -- and practitioner -- of the art of conversation, but I do see some problems lurking in this type of approach. As long as the institutional managers base their investment decisions on their own analysis of facts which are publicly available, they are simply doing the job for which they were hired. But if they are able to obtain from the issuer, because of their economic power or for other reasons, information that is not available to those with whom they are trading in the public market, it raises serious questions of law and propriety.

I need only advert to the Commission's opinion in the Cady, Roberts case to indicate the type of problem that can arise out of privileged access to facts. Cady, Roberts was an extreme situation, in the sense that the information which was involved would obviously have an immediate and significant impact on the market price of the security. But we have recently received indications, which are very disturbing to me, that premature disclosure of corporate information to limited groups of people who are in a position to act on it may be more prevalent than we had supposed. I do not mean to imply that institutional managers or analysts are deliberately seeking information which would give them an unfair advantage over those with whom they deal. But the problem is there, and the corporate managers, the institutional managers, and the SEC must all recognize its existence and take effective steps to deal with it.

Our disclosure requirements were developed in the context of so-called "public offerings" to supposedly unsophisticated investors. Yet, paradoxically, in many cases it may be the sophisticated investors who can make the best use of the extensive disclosures which the securities laws require. In fact, one important purpose of the prospectus requirement is to enable the dealer -- who is a professional in the securities business -- to make an informed judgment as to whether a particular security is a suitable investment for his unsophisticated customer.

We have long recognized an exemption for sales to the "more sophisticated" institutional investors, even where substantial numbers of purchasers were involved, on the theory that these purchasers could gain access without our assistance to the information they needed to make intelligent decisions. It would be a great loss, however, if the declining importance of individual investors led to a decrease in "public offerings," so that the pool of generally available information elicited by the registration requirements of the Securities Act of 1933 began to dry up and to be replaced by a market in which each large investor sought his information directly from the issuer.

The power of the institutions to obtain information is simply one manifestation of their generalized power over the companies in which they invest. This is a subject about which you can undoubtedly tell me more than I can tell you. The institutions have voting power and market power -- they can vote or sell the shares they have, and they can buy the shares they do not have. But as yet we have very little reliable information about the extent of their power and the manner in which it is being exercised. We do know that they have in the most cases (there have been some notable exceptions) exercised extreme restraint -- one study has described them as "silent partners." But where there is power, there must be responsibility, and the institutions which are eagerly increasing their stockholdings must begin to accept increasing responsibility for the managements who are elected by their votes and are influenced by their decisions to buy and sell. We may not be too far from the pattern which is common in the civil law countries, in which an operating board runs the company subject to the review of a supervisory board which represents the interests of the shareholders. A development of this sort poses an enormous challenge to our traditional concepts of corporate responsibility.

At the outset, I said I was going to examine three sets of relationships in which institutional managers were involved. There is a fourth type of relationship, applicable to an increasing number of institutions, with which I am equally concerned. I refer to the relationship between the institutional managers and those who control <u>them</u>. In the case of the non-insured pension funds, more than fifty percent of their total assets is managed by a small number of banks. A substantial portion of the remainder is managed by the companies whose employees are the beneficiaries. In the area of the mutual funds, we have already seen a trend toward public ownership of the investment advisers, and we can now discern the beginnings of a trend toward acquisition of investment advisers by industrial companies in unrelated lines of business. We already have examples of advisers which are subsidiaries of a communications company, a rubber company, and a brewery. The investment adviser to the largest fund complex is controlled by a holding company which also owns substantial interests in railroads and other enterprises. Thus, the process of diversification, or "conglomeration" makes it increasingly difficult to define the responsibilities of the managers of the institutions, who may in some cases be obligated to serve the business interests of the very companies in which they invest.

I have wandered in my talk over a vast range of problems connected with the growth of institutional investors. Some of them have been pretty clearly identified, and we are taking steps to deal with them. Others are only dimly perceived at the present time, and we will require further understanding and experience to deal with them effectively.

But I do not want to leave you with the idea that we view institutional growth only in terms of problems. The institutions have brought new money and new vitality to our securities markets, and they have enabled broad segments of our population to participate in the growth of American business on a sensible and profitable basis.