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SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
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THE CHANGING ENVIRONMENT FOR PRIVATE PENSION PLANS

An Address By

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October 7, 1971

American Pension Conference
Hotel Roosevelt
New York, New York

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Our American system of private pension plans is a tribute not only to the underlying strength of the American economy but also to the ingenuity and farsightedness of labor, management and the investment community. These diverse, multifaceted plans provide substantial retirement and other benefits for employees and their families that would not have been thought possible not too many years ago. They give thousands of employees, many of them persons who would not otherwise have become investors in corporate securities, an important stake in the progress of the companies they work for and at the same time provide them with a sense of economic security and the assurance that in their declining years they will not find themselves discarded in the wake of our industrialized society.

It requires something less than keen perception to recognize that the environment in which these employee benefit plans operate will undergo rapid change in the days ahead. The stakes are too great for it to be otherwise.

Since 1950 the number of employees covered by these plans has more than tripled---rising from approximately 10 million in 1950 to over 30 million in 1970---or about half the wage and salary force in this country. It is currently estimated that 42 million private employees will be covered by 1980. The economic values committed to these plans is staggering. The book value of pension plan assets already stands at about $137 billion, and they are expected to grow to over $215 billion by 1980--- an increase of 37% in less than a decade. In order to round out the picture, I should point out that pension fund assets set aside for public employees are already at $122 billion and are growing as fast, if not faster, than those committed to private plans. Because of the importance of these assets to the hopes and expectations of millions of Americans, steps should be taken now to make certain that those assets do not become the markers in "The Money Game" of the 1970's.

The nation's private pension plans have powerful impact on the securities markets, which the SEC regulates, and on the earnings of the corporations whose shares are traded in those markets, and the SEC has the responsibility to see that those earnings are reported fairly and accurately.

Perhaps an even stronger impact is the influence exercised on equity values by the $130 billion of private pension funds, half of which is already invested in equity securities, and the $14 billion which flow into pension plans each year. Yet, despite this influence on markets, earnings and values, the SEC's authority and influence over the nation's plans is minor and peripheral.

It is clear, however, that the Federal Government is likely to extend its supervision over private pension plans.

As I canvass the existing legal environment for these plans, I am reminded of the situation that existed before the adoption of the Investment Company Act in 1940. Very few, if any, of the protections afforded to investors under that legislation are available to employees. Except in the case of plans negotiated between union and industry, employees have nothing to say about the terms of the plan, the amount of their contributions or the way in which the plan will be operated. Yet, in a very real sense, employees are as much investors in the plans in which they participate as if they had decided to purchase shares in a mutual fund. The stakes here, however, are even higher, because the

assets committed to these private plans are already about two and one half times the amount of assets invested in open-end investment companies and are likely to grow even faster. Employer contributions alone have swelled at the rate of 10% a year since 1965, and there is no basis for believing that they will not continue to expand in the years ahead. I am not at all confident that the legal protections currently available to employees are adequate to cope with the mounting pressures on employers and plan managers to adequately fund the liabilities that are steadily accruing under these plans.

As you know, legislation has been introduced in Congress in the past several years to amplify the benefits to participants in private pension plans and to strengthen the protection of their rights and interests under the Welfare and Pension Plans Disclosure Act. A number of these proposals are quite controversial and would regulate such matters as vesting, funding and portability. I do not think that any firm conclusions can be reached on any of those important questions until we have had an opportunity to explore the economic impact of those requirements on the companies who, after all, will have to provide the money. I do not

think that it would serve the national interest if the imposition of stringent vesting and funding requirements would result in the bankruptcy of employer companies or in the sharp curtailment of funds otherwise available for investment in the business. Nor do I think that it would serve the long range interests of employees generally if the effect would be to discourage employers who do not now have pension plans from adopting those plans or result in others narrowing coverage and benefits. On the other hand, I can think of nothing more likely to undermine the private pension system as it has developed in this country and destroy the industrial harmony necessary to the growth of our economy than the arbitrary deprivation of plan benefits. To the extent that this legislation is designed to make certain that employees receive the benefits that they have worked for and earned, I for one welcome it.

I want to describe for you some of the problems that I see emerging from the rapid growth of pension plan assets and the ways in which we at the Commission hope to come to grips with them.

Let me now be a little more specific about the Commission's jurisdiction. Although employee pension and profit sharing

plans share many of the characteristics of investment companies, they are not generally subject to our jurisdiction. Section 3(c)(11) of the Investment Company Act, as amended last December, excepts from the definition of "investment company" any pension or profit sharing trust which qualifies under Section 401 of the Internal Revenue Code and any insurance company separate account whose assets are derived solely from pension or profit sharing plans which qualify under Section 401. The Securities Act of 1933, which was amended at the same time, now specifically exempts from the registration, but not the anti-fraud, provisions of that act interests in Section 401 qualified trusts and separate accounts, other than Keogh plans. Although some insurance company separate accounts are fully registered under the Investment Company Act and some mutual funds are used as investment media for pension and profit sharing plans, the vast bulk of the sums entrusted to these plans are not now subject to any effective scheme of regulation.

Although the Commission does not directly regulate the activities of pension plans, I do not want to give you the impression that we are not alert to problems that have arisen in areas that are subject to our jurisdiction.

As pension funds have commenced to rival the corporations which begat them in market value and as the annual contributions necessary to fund them become larger in relation to the corporation's net income---last year, for example, the $1.30 per share loss shown by American Airlines would have been a 50¢ profit if it had not been required to contribute $37 million to its pension fund, and in the year before that, Western Electric contributed $128 million to its plan, or an amount well in excess of 50% of its reported profits for the year---the possibility that changes in pension contributions and the method of calculating them may distort the net income on which market values are so heavily based becomes of increasing concern to the SEC. As you know, there can be great flexibility in the degree to which the past service liability of pension plans is funded, and changes in interest or turnover assumptions can significantly reduce the amount calculated as necessary to fund pension costs.

Under the authority of Section 10 of the Securities Exchange Act of 1934 the Commission has adopted rules designed to prevent fraudulent conduct in connection with the purchase and sale of securities, and, to the extent that abuses

involving securities transactions arise in the pension fund area, we intend to take forceful action. In a case pending in the Federal District Court here in New York City we brought charges against certain individuals who took over a large company through a tender offer, obtained control of the substantial assets contained in the company's pension funds and thereafter diverted those assets for their personal benefit. We are also going to take a look at other areas where the Commission, notwithstanding the statutory limitation on its powers, can effectively safeguard the interests of investors and employees. Regulation S-X, which is applicable to a variety of corporate financial statements required to be filed with the Commission under the laws we enforce, currently contains a provision requiring certain kinds of disclosures with respect to pension and retirement plans. In August we issued for comment a revision of that provision, Rule 3-19(e), increasing the required disclosures, and as we develop more information concerning the activities of these plans and the impact that they have on stockholder and employee interests, we may decide to further augment those requirements. Furthermore, in examining the financial statements filed with the Commission, we are going to make

sure that any material changes in the actuarial assumptions underlying the computation of employer contributions are adequately disclosed. If a company has gotten itself into a fix by failing to adequately fund its pension liabilities in the past or is experiencing a bad year and hopes to reduce its annual contribution, we do not want it to "solve" the problem by an undisclosed, upward revision of the plan's expected return on investment.

The proposed amendments to the Welfare and Pension Plans Act requiring increased disclosures in pension fund annual reports and imposing a federal standard of fiduciary responsibility are welcome first steps in bringing about effective regulation. State law has not been effective in controlling abuses because its reach is limited and the scanty information presently available to plan participants concerning investments and the like rarely comes to the attention of state authorities. The Commission's Institutional Investor Study recommended increased disclosures in two general areas. The Study urged that all plans be required to report the current market value of plan assets at the reporting date as well as their costs. This would provide

participants with useful information concerning the investment performance of the plan and would also create a uniform method of reporting applicable to all plans, thereby permitting comparisons to be made among plans. The Study also recommended that plans be required to report securities holdings by issuer as well as cash flow and details of portfolio transactions. That data would permit some degree of supervision over the kinds of investments being made and risks being undertaken and provide a check on the development of improper investment relationships. Although these disclosures cannot be regarded as an adequate substitute for effective, overall regulation, they would shed light for the first time on important areas of pension plan activities. Since the 1930's disclosure has been the primary instrument for assuring honesty and fair dealing in our securities markets, and it has been successful. Coupled with a federal standard of fiduciary responsibility and a right on the part of plan participants to institute private actions to enforce that responsibility, it can prove to be a potent weapon in discouraging potential wrongdoers.

I want to step back for a moment and look at the broader aspects of disclosure.

The Institutional Investor Study convinced us that in order to develop a coherent approach to the development of a national system of securities markets and discharge our responsibilities under the securities laws, great improvement is needed in the collection of information about institutional investors and their activities in the equity markets. Although vast sums of money are currently owned beneficially by various types of institutions, reports concerning their holdings and transactions are either inadequate or non-existent. Banks and insurance companies report to agencies other than the SEC, and no reporting at all is required of self-administered public retirement funds and non-fund investment advisors. Although private employee benefit plans are presently required to make certain disclosures in their annual reports under the Welfare and Pension Plans Disclosure Act, those reports omit important information concerning securities transactions and the value of plan holdings. The proposed legislation comes to grips with this information gap to the extent that it relates to

employee benefit plans, but I think that it is time we developed a uniform system of reporting for institutional investors across the board. With the stakes so large for the national interest, I see no reason why Congress and the regulatory agencies ought not to have the most authoritative, up-to-date information that modern technology can make available. Only by having that data can we discharge our obligation to maintain fair and honest securities markets for the protection of all investors.

Let me finally discuss with you how these private pension plans and the contributions to them, and the way in which those contributions are invested, do affect our securities markets, the earnings of our corporations and equity values. Today, institutions own about 30% of all outstanding stock in the United States and account for some 60% of the trading volume on the New York Stock Exchange. The pension funds with their $66 1/2 billion are the largest class of institutional investor. During the decade of the 1960's, the pension funds bought almost $40 billion worth of stock. Today, pension funds are the largest source of new money---some $5 billion a year---coming into the market.

The growing impact of pension funds on securities markets and security values comes from three directions:

1. the growth of pension funds;

2. the shift of pension funds into common stock---16% in 1950, 43% in 1960 and 62% in 1970; and

3. the more aggressive management of pension funds which has led to increased turnover---following the trend of mutual funds---moving from a 12% turnover rate in the early 60's to a 45% turnover rate in 1969.

It is this growing turnover rate of pension funds and other institutions which has radically transformed our securities markets and given rise to the knotty problems of negotiated rates, market fragmentation and institutional membership with which the SEC is grappling these days.

We have a very different market than we had ten years ago. Then, a large block of 10,000 shares or more would be traded about every hour---5 or 6 times a day. Today, we see this kind of trade about every 2 minutes---150 times a day. During the first half of 1971, block transactions on the New York Stock Exchange ran 7,000 a month and accounted for 18% of total volume. Meanwhile, from 1968 to 1971, odd lot volume fell from 10% of total volume to 5% and all trades of 200 shares or less fell

from 41% of total volume to 24%. Over the full decade of the 1960's individual transactions shifted from 60% to 40% of total volume and professional and institutional transactions went from 40% to 60%. This enormous and steadily accelerated shift has created a different market and is developing a different industry, and we must fathom how they should be structured and fit together to maintain the qualities of depth and liquidity which has made ours the best capital market in the world and to meet the huge money needs immediately ahead.

Think of what this market system will have to absorb. We have noted this phenomenon of 150 trades a day of 10,000 shares or more mostly by institutions that account for more than 50% of the trading. It comes not so much from new savings coming into our institutions, although that is impressive too, but from pension funds and life insurance companies putting a larger portion of their portfolios into stocks and from more active trading by institutions. In the early 60's, mutual funds were turning over their portfolios 12% a year. Turnover moved to 45% in 1969 and is probably higher in 1971. To meet this, there has developed the phenomenon of block positioning in which a relatively

few houses will sell a portion of a large block and take the balance into inventory. This phenomenon has maintained a liquidity for these large blocks at or close to the price for 100 shares---a phenomenon we see nowhere else in our economy. Keep in mind that an institution may have researched a company for months and decided that its prospects do not satisfy its standards, yet it has been able to dispose of a large block of its shares at close to what the public pays for 100 shares, and that is the work of a handful of firms.

The expanded institutional presence in the marketplace has given rise to another type of firm---the institutional firm attracting business through its research capability. Somewhere between 20 and 50 firms with a cadre of highly knowledgeable and well paid analysts perform a critical function in pricing the market and helping it perform its critical function in directing the flow of economic resources.

There has been an erosion of the central market. Institutional trading, as it increased in volume, has drifted to the regional and over-the-counter markets and to the third market and now the fourth market. If you like this, you call it competition. If you don't, you call it fragmentation. Whatever it is, it's a fact, although the New York Stock Exchange manages to keep 80% of the volume of trading on exchanges. The decision to permit regional exchanges to trade in stocks listed on the New York Stock Exchange was made years ago, and the question that confronts us now is whether we can blend all these markets into a central market system which will have additional market making capacity. I am hopeful that the inquiry we will launch on October 12 will show us how a system of full information in all markets, giving prices and volume and quotations in all markets, and a substantially uniform system of rules can develop our existing markets into a national market system which will have the combined depth and market making ability of all our existing markets and enable anyone to know where he can get best execution.

When we have come to grips with all these problems, we will have a better market system---one which will merit the confidence of investors of every kind and size both here and abroad and which will maintain our unrivaled ability to mobolize the capital resources needed to develop our national economy in the years to come.