REMARKS OF RICHARD B. SMITH, COMMISSIONER,
UNITED STATES SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE NATIONAL INSTITUTIONAL TRADER CONFERENCE,
NEW YORK CITY, JUNE 11, 1969

"The SEC's Thinking on the Impact of Institutions"

A.

Let me first thank Mr. Kaplan and Miss Fiske for having invited me to speak to this Institutional Traders Conference.

It is a valuable endeavor to bring you together for informed discussion. You are the participants in this relatively new, highly specialized and now major activity in the nation's capital markets. Too often participants in a significant process do not have an opportunity to disengage themselves and consider its whole meaning.

At the outset, of course, despite the title given to my talk, I should make it clear that today I am not speaking for my other colleagues on the Commission, or for the staff of the Commission, or for the Commission's Institutional Investor Study.

Having thus limited my talk to my own thinking, it will be mercifully brief.

B.

Block trading of course, is the unique market expression of institutional investment. If there has been a common ground of agreement within the industry and government over the last several years, it is that institutional investment has become increasingly, dominantly, important in our securities markets. And the securities markets in turn have steadily reflected a larger and larger part of our national savings.

What are we talking about in dollars?

Ten years ago institutional equity holdings totaled just over $65 billion and represented about 25 percent of the total equities then outstanding. At year end 1968, they totaled an estimated $258 billion, 34 percent of the $761 billion total of outstanding corporate stocks. Institutions hold an even larger portion of the $170 billion total in outstanding corporate bonds, but we have no precise data now.

A breakdown of institutional holdings by form of institution is as indicative as a static point in time can be:

More than half ($132 billion) is administered by banks in the form of pension funds, personal trusts and common trust funds. In addition, and not reflected in these aggregates, banks had in house about $35 billion of stock on some sort of agency basis.

Banks, therefore, are clearly the predominant equity holders. However, it is important to keep in mind the variety of purposes of investment accounts administered by banks and the various legal constraints circumscribing the bank activities in these accounts. In addition there is a considerable heterogeneity in the banking community itself which makes generalized statements regarding uniform nature of their activity difficult indeed. It is also an area in which less relevant data exists than for other institutional investors.

Next in order of size in 1968, but less than half the bank total, were investment companies with about $60 billion of stock. This figure, however, does not reflect additional funds that investment company managers may administer other than as advisers to the mutual funds.

Insurance companies, including both life and casualty, and including insured pension funds and separate accounts, probably held something like $28 billion in stocks. The financial resources, of course, of life insurance companies are considerably larger than these figures reflect.

Foundations and college endowment funds have around $24 billion invested in common and preferred stocks. Self-administered pension funds are around $12 billion.

C.

Even that static picture of portfolio holdings today is expressive of the dynamism in the way institutional assets are in fact administered. Pension funds as a grouping had common stock holdings of almost $45 billion in 1968, some administered by banks, others by insurance companies as separate accounts or as part of their regular portfolios for insured pension plans; other pension funds were self-administered, and still others used independent investment advisory organizations. Some larger funds have several different managers administering separate portions of the same fund.

I cite this to point out that our Institutional Investor Study, I expect, will necessarily be looking at institutional investment growth from two perspectives. One, the forms through which savings have been collected for investment -- for example, into pension funds out of corporate earnings and individual savings. Second, and probably more pertinent to this audience, the ways in which the collected savings have been organized for investment, that is, who directs the investment, and how? Thus the Study would be looking, in an overall sense, at the flow of funds into institutional forms, such as pensions, and then the flow of funds from the institutional forms into the markets, and here the critical classification will be who directs the investment and how it is directed.

Similarly, in looking at mutual funds, I would expect the Study to be interested in considering investments by entire fund complexes, and in the aggregate, other managed accounts of the same advisor. I am not suggesting that the Study is looking for anything wrong in any of this, in the possible differences between the groupings for the purpose of collecting savings into funds and the groupings for the purpose of investing the funds in the markets. Indeed, I would expect there may be numerous efficiencies and equities for different classes of investors in the variety of groupings. But at this point the Study is planning to take a more sophisticated look at the professional groupings for investment in order to gain a better understanding for all of us of the full impact of institutional investors on the markets.

We are trying to undertake this with no preconceptions. Maybe the Study could take its approach from an inscription that Professor Cary described, in another context, as being engraved in stone over the door of a Unitarian Church in London:

> Between dogmatism on the one hand and
> skepticism on the other, lies our way:
> open-minded certainty.

D.

Now I have already referred several times to the Commission's Institutional Investor Study and some of you may not be familiar with its background, origin and organization. So perhaps at this point I should spend a few moments describing it and saying something of its present status.

The growth of institutional investment was most visible to the SEC, of course, through registrants under the Investment Company Act of 1940, primarily mutual funds. The substantial growth of these companies in the post-war years led to their intensive study beginning in 1958 with the commissioning of the Wharton School Report. It was followed in 1963 with the Report of the Special Study of Securities Markets, Chapter XI of which also was devoted to mutual funds. The Commission's 1966 study on the Public Policy Implications of Investment Company Growth was again directed at aspects of the mutual funds.

A portion of Chapter VIII of the Special Study Report did discuss explicitly the growing importance in the stock markets of institutional investors as a whole. The Special Study had collected certain data and analyzed aspects of block trading. It was a very limited treatment in the context of a general study of securities markets. That study recommended that more continuous data concerning institutional participation in the securities markets be obtained and published. I believe the Commission through its current Institutional Investor Study will make very concrete recommendations on what, when and how such data should be continuously reported.

The only other prior governmental look at institutional activity as a whole in the stock markets, of which I know, was the 1955 Staff Report of the Senate Committee on Banking and Currency, entitled Factors Affecting the Stock Market. Chapter V dealt with individual and institutional investments in stock. That study had collected certain data on institutional participation in particular securities for the first time.

Since 1955, and even since 1963, there has been the very significant growth of institutional trading of which you here are particularly aware. It was probably this dramatic increase in trading activity, both absolute and proportional to the rest of the market, reflected in ever increasing institutional portfolio turnover rates, in larger and larger blocks, and occurring in what many considered a speculative market, that sparked the current attention to all aspects of institutionalization in the markets.

E.

The resolution that led to the Congressional authorization was introduced in December of 1967 jointly by Congressman John Moss of California and Congressman Hastings Keith of Massachusetts. They are the chairman and ranking minority members respectively of the Subcommittee of the House Commerce Committee that has oversight over us. Hearings were held on the House resolution and a comparable Senate resolution during the early summer of last year, and the resolution became law at the end of July.

The resolution directed the Commission to make a study of the transactions and holdings by institutional investors of all types in order to determine their effect on the securities markets, the issuers of securities and the public. The resolution authorized the Commission to form a special staff to conduct the study within authorized appropriations of $875,000. Finally, the resolution directed the Commission to establish an advisory committee with which it is to consult on a regular basis.

Initial separate funds were appropriated for the Study in October of last year, a director was selected in December, and, after consultations with a number of industry organizations, the Advisory Committee was formed in January of this year. Donald Farrar, an economist and professor of finance at Columbia, was appointed director. The Advisory Committee is composed in main of knowledgeable people from the financial community. John Whitehead, chairman of the research committee of the Investment Bankers Association, is its chairman. The Advisory Committee, incidentally, is proving to be an effective and constructive instrument. It includes members associated with institutional investors themselves as well as market organizations.

By February most of the staff had been picked. However, because most came from university positions and had academic commitments, they have for the most part only recently come aboard full time. Only two professionals, an economist and a lawyer, were drawn from the regular staff of the Commission.

In keeping with the clearly understood nature of the undertaking as being an economic study, the staff is built around nine economists and four lawyers, supported by computer programmers, financial assistants and administrative personnel. The economists come from universities all over the country. They are, from all appearances, a competent group, as are the lawyers on the Study.

The Study has had extensive discussions and cooperation from the Federal Reserve Board and we are in constructive contact with the other federal banking agencies, the Labor Department, the Commerce Department and other parts of the federal government. The Study staff already has done an extensive amount of interviewing with various institutions, broker-dealers and investment advisers, as well as members of the Advisory Committee. Some of you, I know, already have seen them. That process will continue and intensify. Right now the Study is working on the data collection questionnaires that require the longest lead time. They are planned to go out this summer.

We presently anticipate being able to send the Study's report to the Congress at the end of next summer, but this, of course, will depend upon the wishes of the Congress.

F.

What are we studying?

Well, the study design is in no way final or complete at this point and so I cannot discuss it more than generally with you today. At an appropriate time Dr. Farrar, the Study Director, will be more explicit. The subject is simply enormous and could expand beyond all belief. As a practical matter we cannot let that happen, and as a result I would be reasonably certain that everyone will have areas that he would have preferred to be studied or particular techniques of study used, but it will not be possible to do everything.

I understand you heard this morning about some of the complexities brought to the securities markets by institutionalization. They are so difficult that there is a natural emphasis to look for someone else to solve all of them -- the Institutional Study obviously cannot do that.

The Study has been organized into four major portions. I'll not dwell on any of them at length.

(1)

The first part is essentially a flow of funds analysis. It will attempt to describe on an aggregate basis the flows of savings to and through institutional investors into various types of financial assets. This portion of our Study has been subcontracted to the National Bureau of Economic Research, whose experience in flow of funds and national income statement and balance sheet analysis peculiarly qualify them for this type of study. Raymond Goldsmith of Yale, whose writings on financial institutions may be known to you, will direct the effort for the NBER. It will update and refine data on historical trends related to the institutionalization of our capital markets that has in some part characterized the last half century.

Data bearing on the concerns expressed so often in the persistent shifts from bonds to stocks in institutional portfolios are expected to be developed in this portion of the Study. So also may the apparent, but conceivably unreal, imbalance between the volume of savings newly collected into institutional accounts and the supply of new equities for investment by them. In view of the fact that retirements of common and preferred stocks exceeded new issuances last year by almost a billion dollars, someone said the situation in equity securities today reminded him of Will Rogers old quip "Buy land. I hear they're not makin' it anymore."

(2)

Now a separate portion of the study will deal with the impact of institutional investors on the companies whose securities they hold. A portion of this influence undoubtedly is exerted through the market mechanism. Here institutional impacts on security prices, as well as participation in new issues, private placements and their implications for the availability of equity funds to new enterprises are of interest. Analogies that sometimes are made between private equity placements in this market and the earlier development of private placements in the market for corporate debt clearly should be pursued.

No discussion of relationships between institutional investors and portfolio companies can be limited, however, to those that transpire through the market. Direct relationships between institutions and issuers, in the institutions' search for information, as voters of shares, and as potential catalysts in the merger and acquisition process are also expected to be examined during the course of the study.

Indeed, the extent of the institutional role in corporate combinations is to me an especially significant area of inquiry. And the proper role of institutions in voting matters requires some analysis -- views among institutions themselves vary greatly. It is a difficult area, but it seems to me that it too must be covered.

(3)

A third portion of the Study will be devoted to analysis of the principal institutional investors. By reason of the time and budget restrictions on it, and because there is a natural priority, the Study will necessarily be concentrating on the principal classes of institutional investors -- the banks, the investment companies, the insurance companies, the pension funds, and foundation and endowment funds. The Study also contemplates looking at some of the more exotic institutions such as hedge funds. They may be important because of their quick market impact or because their investment techniques, if successful, may tend to be imitated. Relatively little data exists in these areas now.

In what way will the Study be looking at them? The study design is not final here by any means, but in general I think it is fair to say that we will be inquiring into what has made them grow and where the most likely future growth, or degrowth, will be. What characteristics have been associated with that growth? The focus will be on the investment managers. The Study is asking itself whether it will be possible to determine the extent to which institutional growth or particular forms of that growth have been accompanied by, or resulted from, any increasing riskiness in the financial assets administered. This will not be an easy objective to carry out, but a general question raised about some aspects of institutional growth has been the extent to which they may have introduced more speculative or riskier assets into institutional portfolios, and what this may mean to the investors or beneficiaries of those institutions.

The other side of this same inquiry is the extent to which institutional trading techniques may have speculative impact on the market generally and contribute to price instability in particular securities. This study, however, falls in a fourth section dealing with market impact.

(4)

For your purposes as block traders I know the most relevant portion of the Study will be that devoted to market impact from institutional transactions.

A primary concern here seems to me to revolve around the extent and nature of the interaction between the small order or public customer markets, especially on the exchanges, and large institutional orders. It seems to me pertinent to study, one way or another, the way in which institutional blocks are assembled or created and the conditions under which they stay together, or are broken up and enter or reenter the auction market.

The Institutional Investor Study staff intends to include a number of projects designed to study the price impacts of institutional trading. I will briefly summarize three of these studies for which plans are relatively far advanced.

One is designed to measure the price impacts of, and perhaps describe market structural responses to, large position changes by institutions. It is argued from time to time that these position changes have a noticeable impact on prices. The object of this study is first to measure these price impacts, and second to determine if there are any systematic relationships between the size and other characteristics of the price impact (for example its magnitude or duration) and other factors such as the size of the position change, the volume of trading in the security, the size of float, the effects on liquidity at and around the time of the change, the market through which the position change is accomplished, the speed with which the position change occurs, and so on.

Although each block trade is to some extent associated with a unique set of circumstances, the Study is interested, for one thing, in learning whether or not it is possible to make valid generalizations about the average impact of block trades as compared with trading a similar quantity of shares in a large number of small transactions. In attempting to make such generalizations it is necessary to allow for such important factors as the volume of trading in a security, its volatility, and the extent of institutional interest. We recognize that arriving at valid generalizations in this area will be a difficult task.

The study of block trading will involve collecting transactions data about shifts in institutional portfolios under a variety of conditions. It also may include an effort to assess the possible price impacts of inquiries, some of which may never be consummated in an actual transaction.

A second study is designed to determine the extent, if any, of parallel action by institutions. Parallel action can be defined as a tendency for all investors in a certain category to buy or sell the same stocks at the same time. To what extent have institutions tended to reach the same investment decision at the same time and what has been the market response? Are any trends discernible? If parallel trading exists what are its causes? Does it have harmful results? Parallel action is impossible for the market taken as a whole, of course, unless the number of shares of stock available should change. Data for the study of parallel action would be obtained by asking institutions to report their purchases and sales on a periodic basis over a number of years in a sample of stocks.

A third study is designed to determine the pattern of institutional trading before and after specific types of events. Among the types of events that are being considered for study are the announcement of tender offers, announcements of new stock issues, suspensions of trading, announcement of proposed dividend changes, and possibly the award of significant government contracts. An objective of the study is to determine if institutions vis-a-vis public direct investors systematically benefit from all news events or from certain types of events. This will require an analysis of institutional trading before and after the event, and of the price impact of the news.

Now I have previously described the increasing importance of institutional investors in terms of the percentage of the total assets they control. There is another dimension to the importance of institutions that is of substantial interest to the Study. It is the tendency of institutions to increase their rates of trading. By the fourth quarter of 1968 each of the institutional groups for which we have adequate data had at least doubled the turnover rates of their common stock portfolios compared to calendar 1964. In some instances these turnover rates had increased threefold. Specifically, during the fourth quarter of last year the turnover rate for property and casualty companies was 16 percent, for private non-insured pension funds 21 percent, for life insurance companies 35 percent and at the head of the list, the turnover rate of open-end investment companies was 56 percent. Taken as a group, the dollar volume of institutional trading for a very broad class of institutional investors has grown by more than 40 percent during each of the last two years. Why?

It has brought institutional participation in the markets up to possibly more than 50 percent and has intensified pressures on the organization of the markets you discussed earlier.

Associated with increased institutional turnover has been the development of some significant new trading patterns, of which the block trade is the most dramatic. This development is so new that a real understanding of it is limited to a fairly small group of persons. Statistical data is extremely limited. The New York Stock Exchange, since the fourth quarter of 1964 has tabulated transactions involving especially large blocks effected on that exchange, 10,000 shares and over. During that quarter there were about 400 such transactions amounting to approximately nine million shares, or three percent of reported volume. During the first quarter this year there were 3,500 such transactions aggregating 95 million shares, or 14 percent of volume. This is about a nine-fold increase in four years -- in market value the increase was from $300 million to $4.1 billion, or almost a 14-times increase.

G.

Well, the Institutional Investor Study is now at work with an able staff and a helpful Advisory Committee. To date the staff has received splendid cooperation from the financial community and I would hope and expect that to continue. After all, we all want the Study to be meaningful and contribute to, rather than detract from, the strength and efficiency of the capital markets of our country. It is something of a unique undertaking for our Commission in the extent to which it is an economist-directed and economic-oriented inquiry. I certainly would hope that the Study would be of sustaining impact and value to the Commission as an institution, as well as to the Congress, the public and the industry.

It is in all our interests, I would hope, that the Study be informative. It cannot be, particularly within our time requirements, without your cooperation and especially your candor. When you are called upon or questionnaired by the staff of the Study, as you surely will be, I hope that you will go out of your way to be responsive. Real-time knowledge gained by them from such as you cannot help but improve the quality of their product. I think you'll find them an objective group. This is not a Study intended to hurt, but to help.

Let me conclude by saying that I trust our relationship will not be like that between the old lady and the boyscouts of whom Chairman Budge once told:

> A scoutmaster asked his troop to report on their good deeds for the day. One scout said that he had helped an old lady cross the street. A second scout said he had too, and a third scout said the same. The scoutmaster asked why it was necessary for three scouts to help one old lady cross the street. They said, "Well, she didn't want to go."

Let's all of us go.

Thank you.