U. S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

Remarks of

David S. Ruder
Chairman

United States Securities and Exchange Commission

Before the
27th Annual Corporate Counsel Institute

October 11, 1988
Chicago, Illinois

THE IMPACT OF INSTITUTIONAL INVESTORS ON LARGE CORPORATIONS

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners, or the staff.

The Impact of Institutional Investors on Large Corporations

I. Introduction

As I appear before this Corporate Counsel Institute audience a year after my October 7, 1987 appearance, let me begin with an understatement: A great deal has happened since I spoke to you last year. With the anniversary of October 19th approaching, I want to share with you some thoughts accumulated during the last year which I believe may be helpful to corporate counsel as advisers to management. I want to discuss with you today an important aspect of the corporate world -- the impact of institutional investors on large corporations.

At the outset, you should recognize that corporate managers may have a schizophrenic attitude towards this subject. As managers they necessarily will be affected by the activities of institutional investors on their corporations. However, since they also may directly or indirectly control large private corporate pension funds, they themselves may have ultimate responsibility for the conduct of these funds, which of course are institutional investors. General Motors, General Electric, and IBM, for example, all have extremely large pension funds -- in fact, these three pension funds ranked among the ten largest in Pensions and Investment Age's "Top 200 Pension Funds". 1/ According to that source, the General Motors pension fund has $40 billion dollars in assets;

1/ See Pensions & Investment Age, January 25, 1988, at 18.

General Electric has $27.3 billion, and IBM has $22.4 billion. 2/ Remarkably, the pension assets of some large corporations, such as Boeing, Chrysler, and General Dynamics, now apparently exceed their net worth. 3/

II. Institutional Investors -- Generally

It is no secret to most of you that institutional investors are playing an important role in our nation's financial markets. The percentage of outstanding stock held by institutions has steadily increased over time. Recent figures show that institutions own about 45% of the almost $3 trillion of public company stocks. Because institutions prefer to invest their portfolios in securities of corporations that offer better liquidity, their holdings tend to be concentrated in the stocks of the very largest corporations. As a result,

---

2/ Id. According to Pensions & Investment Age, the top ten pension funds as of January 25, 1988 were as follows:

Teachers Insurance and Annuity Association/College Retirement Equity Fund (TIAA-CREF),	$66,171,000,000
Cal. Public Employees' Retirement System,	$44,036,000,000
General Motors,	$40,000,000,000
New York State/Local,	$38,747,000,000
AT&T,	$37,577,000,000
N.Y.C. Retirement Systems,	$33,633,000,000
General Electric,	$27,300,000,000
California State Teachers,	$23,714,000,000
New York State Teachers,	$23,035,000,000
IBM,	$22,457,000,000

The 100th ranked fund was: Consolidated Edison, $2.853 billion and the 200th ranked fund was: Army and Air Force Exchange, $1.305 billion.

3/ Gray, New Directions in the Investment and Control of Pension Funds (Investor Responsibility Research Center, Inc. 1983).

institutional investors as a group own 50% or more of many large companies, such as Texas Instruments, Eli Lilly & Co., and Citicorp -- to name a few.

Equally important, institutional investors have become more active market participants. Institutional trading is now estimated to be between 70% and 80% of market volume, resulting in institutional domination of our markets. 4/

The existence of increasingly large institutional holdings in today's markets suggests that some notions of corporate power and accountability may need to be re-examined. Fifty-five years ago, Berle and Means wrote their seminal work The Modern Corporation and Private Property 5/ in which they

---

4/ The discussion of institutional holdings and market volume contained on pages 2 and 3 of this speech is based on information from the following sources: M. Eisenberg, The Structure of the Corporation, 53 (1976); L. Lowenstein, What's Wrong With Wall Street, 57-58 (1988); Lemke and Lins, Disclosure of Equity Holdings by Institutional Investment Managers: An Analysis of Section 13(f) of the Securities Exchange Act of 1934, 43 Business Lawyer 93 (November 1987); Robinson, Developing and Analyzing a Corporate Shareholder Profile, in Shareholder Activism: The Emerging Role of Institutional Investors 116 (Practicing Law Institute 1987); and data obtained by the Securities and Exchange Commission pursuant to Rule 13f-1 and Form 13F as of June 30, 1988 and published by CDA Investment Technologies, Inc. in Spectrum. It is difficult, however, to obtain precise statistical data regarding institutional shareholdings because information regarding certain types of institutional investors is not readily available. The estimates of institutional holdings of New York Stock Exchange listed stocks contained in the New York Stock Exchange Fact Book, for example, does not include data respecting bank-administered trust funds, private hedge funds, and non-bank trusts.

5/ Berle & Means, The Modern Corporation and Private Property (1933).

observed that because corporations were owned by widely dispersed groups of individual shareholders the ownership of corporations was separated from control. They were concerned about the plight of shareholders unable to influence corporate management. Today, instead of a faceless group of powerless investors each with only a small interest in a company, institutional investors, with their significant shareholdings and substantial market presence, are emerging as a new power group.

Over the years, the Commission has become aware of the increasing importance of institutional investors, and it has demonstrated its concerns in a number of ways.

In 1971, the Commission issued its "Institutional Investor Study Report." 6/ This economic study included detailed information regarding the portfolios of institutional investors, their trading activities, and their impact upon the markets. As a result of the difficulties encountered by the Commission in obtaining information regarding institutional holdings and trading, the Commission recommended that the Securities Exchange Act of 1934 (Exchange Act) be amended to provide for more public disclosure of institutional investment activities. As a result of this recommendation, Section 13(f) was adopted in 1975 and the Commission instituted its institutional disclosure program. 7/ Aimed at institutional

---

6/ Institutional Investor Study Report, H.R. Doc. No. 64, 92d Cong., 1st. Session (1971).

7/ Lemke and Lins, supra n.4, at 99.

managers who control large securities holdings, this program requires all managers with investment discretion over $100 million in equity securities to report those holdings to the Commission on Form 13F. 8/ For the quarter ended June 30, 1988, the Commission received Form 13F reports from 1,691 managers who supplied information on securities holdings valued at almost $1.2 trillion. 9/

By the mid-1970s, Ray Garrett, Jr., then Chairman of the Commission, found institutional investors under attack both by the press and by Congress. In response, Chairman Garrett took the position that institutional investors were not "bad guys to be punished." He suggested that the focus of debate should be shifted from the evils posed by institutional investors -- such as excessive concentration of power -- to their potential for contributing to a healthy market environment. 10/

8/ Pursuant to the Exchange Act Section 13(f), the Commission has adopted Rule 13f-1, which requires reporting by certain institutional investment managers to file reports with the Commission on Form 13F. In 1987, the Commission adopted Rule 13f-2(T), which permits investment managers to file their reports on magnetic tape through the Commission's EDGAR System.

9/ Telephone interview with Robert Levy, President, CDA Investment Technologies, Inc. (CDA) (October 5, 1988). CDA gathers information provided in the publicly available Form 13F and publishes a compilation of this information in the publication, Spectrum.

10/ See generally, Garrett, Address to the New School for Social Research: "Institutional Investors and the Securities Markets: A Regulator's View," New York City (January 26, 1974).

Recently, the Commission acted to encourage increased participation by institutional and other investors in corporate governance matters by eliminating the 25% limit contained in its shareholder proposal rule, Rule 14a-8(a)(1)(ii). 11/ Prior to the Commission's recent action, the rule had limited the number of shareholders that could be contacted if the proponent also wished to have its proposal included in a company's proxy materials.

Today, institutional investors have major responsibilities as the managers of other people's money. As corporate owners, they gradually may be overcoming their reticence to influence the management of the companies whose shares they hold. As market participants, their trading strategies have profoundly affected our marketplace. Given the role of institutional investors as professional money managers, corporate owners, and market participants, it is important to ask: "In what manner and for what purposes should institutional investors exercise their enormous powers?" The answers to these questions will have a profound impact on your corporations as well as on modern economic developments.

III. Institutional Investors and their Duties

What is an institutional investor? Many diverse entities may be included within the term "institutional investor". For the purposes of these remarks, the identifying characteristics

---

11/ See Exchange Act Release No. 34-25217 (December 21, 1987), 52 FR 48977.

are "very large" and "managers of liquid assets for others." Within the institutional investor category are: investment companies, insurance companies, public and private pension funds, college endowments, charitable and religious endowments, bank-administered trust funds, private hedge funds, and non-bank trusts. The largest of these institutions own truly enormous pools of assets. For instance, TIAA-CREF 12/ controls $66 billion in assets; the Prudential Insurance Company, $76 billion; Wells Fargo Bank, $54 billion. 13/

There are a wide variety of entities encompassed within the term "institution" and their duties, investment goals, and regulatory frameworks vary widely. From the corporate perspective, an excellent example of this phenomenon is the difference between a private corporate pension fund and a public pension fund. Both types of pension funds serve similar constituencies -- individual employee beneficiaries. However, private pension fund managers manage pension benefits under ERISA 14/ requirements, which include federally-imposed statutory standards for the conduct of pension fund trustees and asset managers. Under ERISA, fund trustees and asset managers must act as fiduciaries and invest pension funds

---

12/ TIAA-CREF is an acronym for: Teachers Insurance and Annuity Association/College Retirement Equity Fund.

13/ Statistical information in this paragraph was obtained from Pensions & Investment Age, December 28, 1987 at 21 and January 25, 1988 at 18.

14/ ERISA is an acronym for: The Employee Retirement Income Security Act of 1974.

prudently and solely in the interest of beneficiaries. Public funds, on the other hand, are subject to state laws with respect to their fund investments. California, for example, has a law 15/ requiring California state trust funds, including the California Public Employees' Retirement System (CalPERS), to divest themselves by 1991 of investments in companies doing business with South Africa.

While institutional investors are clearly not a homogeneous group and have different objectives and goals, nonetheless, the large majority of them serve as managers of the money of others and owe duties to beneficiaries. In a modern market environment, I believe that the increasing power wielded by institutional investors necessarily broadens the scope of the duties they owe to their beneficiaries. In the long run, institutional investors cannot meet the investment objectives of the persons whose savings they invest without the existence of healthy corporations and capital markets. As a necessary corollary, therefore, institutional managers also must take into account the broader effects of their actions or lack of actions with regard to both corporate governance and investment decisions. In turn, corporate managers should recognize the power of their institutional shareholders and take steps to be responsive to them.

15/ *See* Cal. Govt. Code § 16644 (Deering 1988), adopted Stat. ch. 1254, § 2.

IV. Institutional Investors as Corporate Owners

As noted earlier, institutional investors play a role as corporate shareholders. Over the years, this role has tended to be passive, with institutional investors routinely voting with management. Today, with institutional ownership in large corporations continually increasing, institutions are replacing traditional individual investors, and it seems inevitable that they will gradually assume the responsibilities of ownership. It seems highly likely that institutional shareholders will insist upon accountability by corporate management. In doing so, they can protect not only their own interests but also those of other individual investors.

Recent developments indicate that institutional shareholders have begun to assert their rights to participate in important corporate decisions that affect their interests.

Pension funds, universities, and church groups have joined with individual shareholders to put social responsibility issues on the agenda of corporate America. In the spring of 1988, six of the twenty largest U.S. pension funds sponsored resolutions on social responsibility issues. In addition, institutional investors generally supported the corporate social responsibility movement by voting their proxies in support of resolutions covering a wide range of social issues including withdrawal from South Africa, non-discrimination in Northern Ireland, nuclear weapons production, and equal employment opportunity. 16/ Pioneered by church groups, the role of institutional investors in advocating corporate social responsibility now appears to be an accepted part of the investment policies of institutional investors.

More important in the long run is that institutional investors have begun to make use of their potential power and influence in the area of corporate governance. The increase in poison pills, golden parachutes, greenmail payments, and other matters affecting the financial future of corporations have begun to awaken institutional shareholders to the desirability of exercising their right to vote.

In the spring 1987 proxy season, institutional investors were actively involved in a variety of proposals submitted to companies concerning corporate governance matters. 17/ For example, in 1987, several large pension funds including the College Retirement Equities Fund (CREF), the California State Teachers' Retirement System (CalSTRS), the California Public Employees' Retirement System (CalPERS), and the State of Wisconsin Investment Board, led a major shareholder campaign to persuade companies to rescind or submit poison pills for

---

16/ See Corporate Responsibility Challenges - Spring, 1988, The Corporate Examiner, Vol. 16, No. 8-9 (1987) and Churches Urge Changes by Corporations on Numerous Social Issues, (Interfaith Center on Corporate Responsibility, February 19, 1988).

17/ See generally Marcil and O'Hara, Voting by Institutional Investors on Corporate Governance Issues in the 1987 Proxy Season (Investor Responsibility Research Center Inc., 1987).

shareholder ratification. 18/ Shareholders at 32 companies voted on anti-poison pill proposals, and, although none of the proposals won a majority, nearly half drew more than 30 percent of the shares voted, and four scored 40% or above. 19/

In 1988, shareholder proposals to redeem poison pills or submit them to a shareholder vote were approved by 61.2 percent of the shares voted at Santa Fe Southern Pacific and by 51.9 percent at USAir Group. Also in 1988, an antigreenmail shareholder proposal at Gillette won with the support of more than 55% of the shares voted. Both the Gillette and USAir Group proposals were sponsored by an institutional investor, the California Public Employees Retirement System (CalPERS). 20/ With recent results as a guide, it seems likely that institutional investors will increase their activities in sponsoring and supporting corporate governance resolutions.

Similarly, institutions have begun to play significant roles in the takeover voting process. All of us recently watched with great interest to see whether Texaco management or Carl Icahn would win the proxy battle at Texaco. Now we are all waiting to see if the California and New York public

---

18/ Heard, A Critical View of the Proxy System, in Shareholder Activism: The Emerging Role of Institutional Investors (Practicing Law Institute 1987) at 81-82.

19/ Marcil and O'Hara, supra n.17 at 5.

20/ See Corporate Governance Bulletin, Vol. V, No. 4, (July/August 1988) at 93.

pension funds that supported Texaco management will be given a voice in nominating directors to the Texaco board.

The institutional role in the corporate governance process also may be strengthened by the Supreme Court decision upholding Indiana's Control Share Acquisition Act. The Indiana statute, and others like it, may have the effect of turning some tender offers into proxy voting contests. As a result, shareholder votes will become more crucial in the tender offer process.

Institutional interest in governance issues is likely to continue because of the extremely large size of some institutional portfolios. The size of these holdings makes it difficult for many institutional investors to shift investments between individual stocks without affecting market prices. Already some large pension funds are necessarily long-term investors, due to their huge cash flows, or, for some, because of passive, index investing philosophies. 21/ Further, the difficulty of predicting market movements in an era of volatility may cause institutions to take a longer term perspective on their investments. The traditional "Wall Street

---

21/ If an investor decides to engage in index investing, the investor will buy shares in all of the companies comprising a well know index, such as the Standard & Poor's 500 Stock Index. The theory behind this strategy is that the broad selection of stocks will track the performance of the chosen index and earn a similar annual return. In the case of the Standard & Poor's 500, the average compounded annual return has recently been about 10 percent. The result of index investing will necessarily be long-term ownership of the companies comprising the index.

Rule" -- sell out if you don't like management -- has become increasingly difficult to follow as institutional shareholdings increase.

As corporate shareholders, institutional investors can play a beneficial role by seeking to influence corporate actions. Their attention to the way that corporations manage their business can have a beneficial effect on corporate goals and operations. By participating in corporate governance in an effort to improve management, institutional investors can also provide stability to the marketplace and improve accountability by corporate managers.

V. Corporate Managers and Institutional Investors

The emerging role of institutional investors in corporate governance has not been entirely welcome to corporate managers. Due to the high turnover in many institutional portfolios, 22/ corporate managers have often discounted institutional investors as shareholders and treated them as "short-term" owners. In addition, corporate managers have resented the increasing activism of institutional shareholders and, in particular, their role in hostile takeover contests.

Paradoxically, while corporate managers dislike the increasing activism of institutional investors, in fact they are not loathe to use their own institutional strength. For

---

22/ For an discussion of turnover in corporate portfolios, see Professor Lowenstein's discussion of "The Performance Game" in Chapter 3 of his new book, What's Wrong with Wall Street, supra n.4.

instance, corporations have become much more aggressive in determining how stock held by their pension plans should be voted. Recent reports indicate that many CEO's have written letters to their counterparts asking them to use their influence with their pension fund managers to support pro-management positions on shareholder resolutions. 23/ Companies that have written such letters include: International Paper Co., NCR Corporation, Anheuser-Busch Cos., American Airlines Inc., and Colgate-Palmolive Co. 24/

Similarly, some corporations do not hesitate to become bidders in hostile takeover contests. Some of the largest takeover battles witnessed over the last year have involved corporations making hostile offers for other corporations. These include Campeau Corporation's bid for Federated Department Stores, Black & Decker Corporation's bid for American Standard, Smith Kline Beckman Corporation's bid for International Clinical Laboratories, Inc., and General Electric Corporation's bid for Roper Corporation. In the Federated Department Stores, International Clinical Laboratories, and Ropers bids, there were also competing bids filed by other corporate suitors. In each of these situations,

---

23/ The U.S. Department of Labor has recently instituted a proxy monitoring program for pension plans covered by ERISA in order to ensure that proxies are voted solely in the interests of beneficiaries, as required by ERISA. See Parker, DOL to Probe 23 on Proxies, Pensions & Investment Age, June 27, 1988 at 1.

24/ See Parker, Proxy Battles Heating Up, Pensions & Investment Age, April 6, 1987 at 1.

the corporate bidders contemplated asset divestitures similar to those used by financial "raiders".

In addition, managements themselves have caused their corporations to go through restructurings and asset divestitures in connection with management leveraged buyouts. One recent example involves Continental Graphics Corporation. Following an unsolicited inquiry from a United Kingdom publisher, Continental Graphics retained an investment banker to conduct a controlled auction for the company. During the auction process, members of senior management submitted a bid for the company and eventually entered into a merger agreement to acquire the company's shares at $17 a share. The leveraged buyout is to be financed with a bridge loan and through the sale of debt and equity securities. Shareholders will vote on the going private transaction later this month. The company has stated that it believes that it will be required to sell three of its subsidiaries and divisions in order to repay the bridge loan.

It thus seems clear that corporations, through their control over pension funds and by their participation in hostile tender offers and asset divestitures, are themselves involved in changing the fabric of corporate America. To an extent they resemble the institutional investors that are frequently the subject of corporate criticism.

Profound changes are taking place in the corporate world and corporations would do well to recognize these changes and to respond constructively to the emerging power of large institutional shareholders. Corporate managers should recognize the potential benefits of increased institutional involvement in their companies. Responsible institutional attention to the manner in which a corporation is managed should offer increased attention to concepts of responsibility to shareholders. Corporate managers who respond to shareholder desires as expressed by institutional investors will avoid charges that they are accountable to no one.

Corporate managers who do respond positively to suggestions by institutional managers may be pleasantly surprised if that responsiveness causes institutional investors to behave more as long-term owners of corporations.

VI. Institutional Investors as Market Participants

The suggestion that institutional investors may develop a longer term attitude toward corporate ownership is consistent with the theory that they will increasingly find it hard to sell shares in the market without affecting price. In this regard, serious concerns exist regarding the impact of institutional investors as market participants. As modern portfolio theories have gained increasing acceptance, some institutions have abandoned attention to long-term individual stock performance, and instead are judging the performance of money managers in relation to the gyrations of the market as a whole. As a result, some money managers tend to focus their efforts on short-term market results rather than on long-term asset growth. The message this short-term investment strategy gives to corporate managers is that they in turn should manage by short-term rather than long-term objectives. This message is inconsistent with long-term growth and stability, which should be of great interest to those who are charged with managing other people's money.

In addition to recognizing the potential problems caused by short-term investment objectives, it is important to note that the variety of new trading strategies embraced by institutional investors may cause significant market disruptions.

As a result of attention to overall market performance rather than individual stock selection, some institutions now desire to trade in the equivalent of all or a portion of their large portfolios, rather than trading in individual stocks. This desire has been satisfied in part by the creation of index trading. It is now possible to buy or sell the equivalent of a portfolio of securities by buying or selling an option or futures index product. It is also possible to do so by buying or selling a portfolio or "basket" of stocks directly by routing orders to buy or sell up to 30,000 shares of approximately 460 listed stocks to the New York Stock Exchange through the Exchange's automated Super Designated Order Turnaround system, called SuperDot.

In connection with portfolio trading (sometimes called "program trading"), some large institutions have developed sophisticated index arbitrage and other portfolio-related strategies. Index arbitrage is the purchase (or sale) of stocks that comprise an index and the simultaneous sale (or purchase) of futures or options on that index. The purpose of such trading is to capture the difference between the value of the index and the collective value of the portfolio of stocks comprising the index. Arbitrage usually reduces differences in prices between the stock index futures and stock markets by pushing up prices in the market where the buying occurs and pushing down prices where the selling occurs.

By helping to achieve closer price correlations between the stock index futures and stock markets, arbitrage facilitates the use of futures to protect or "hedge" the value of stock portfolios. The most obvious hedging technique involving futures is the sale of a stock index future by the owner of a portfolio of stocks. The stock index futures position will increase in value as the prices of the underlying stocks decline, thus protecting the portfolio owner against market decreases without requiring the sale of the portfolio securities. Hedging is seen as desirable by portfolio managers as a means of reducing market risk.

"Portfolio insurance" was a hedging strategy in widespread use in the United States before the October 1987 market break. Under one version of this strategy, stock index futures were sold when the value of the portfolio decreased a certain percentage. The sales of futures were thought to be less costly and quicker than the sale of stocks, thereby offering a means of controlling risk for a broad-based portfolio in a declining market. If the futures markets became congested and too costly, some portfolio insurance plans called for sales of stock instead of futures.

The institutional use of new strategies during the October 1987 market break raised a number of serious questions. Large stock and futures sales by institutions pursuing a variety of arbitrage and portfolio insurance strategies, while not the "sole cause" of the market break, contributed to the market decline. During certain critical trading periods on October 19 and 20, index arbitrage or portfolio insurance, or both, accounted for between 30% and 65% of total New York Stock Exchange volume in the stocks that comprise the Standard & Poor's 500 index. These figures lead to the conclusion that on October 19 and 20, institutions holding multi-billion dollar portfolios simultaneously pursued similar strategies in a declining market, causing a rush for the exits that accelerated the decline.

Because of the flaws in this strategy exposed by the October 1987 market break, many institutional investors have abandoned portfolio insurance. Some of these institutions have initiated "asset allocation" strategies that utilize the stock and futures markets to maintain certain ratios of stocks, debt, and cash. Although these strategies do not seem to have the same potential for exacerbating market declines as did portfolio insurance strategies, they are not likely to prevent portfolio selling in declining markets.

The potentially disruptive effect of institutional transactions on the marketplace becomes apparent through analysis of some relevant statistics. Institutional ownership of New York Stock Exchange stocks totals approximately $1.45 trillion. If the daily volume of New York Stock Exchange trading is 200 million shares, the daily dollar volume of that trading will be approximately $7 billion. It should be obvious that decisions to sell even small percentages of portfolios containing $1 billion or more in New York Stock Exchange shares can result in enormous downward pressure on the stock market.

I believe institutional investors should review their market objectives and abandon their short-term horizons. Institutions that exacerbate the markets by "running for the exits" when the market appears to be declining may indeed be acting contrary to their own long-term interests by creating substantial, volatile, and undesirable market declines.

VII. Conclusion

The time has come for both institutional investors and corporate managers to recognize the power and permanence of institutional corporate ownership. Institutional investors must recognize the new era by behaving responsibly as corporate owners and as market participants. Corporate managers in turn should exhibit greater sensitivity towards institutional shareholder interests. If the result is that long-term perspectives are substituted for short-term outlooks, the benefits to our economy should be great.