INSTITUTIONAL INVESTMENT: SOME CURRENT DEVELOPMENTS

An Address by
The Honorable Manuel F. Cohen
Chairman, Securities and Exchange Commission

Before the
American Pension Conference

New York City
May 28, 1968

It is a great pleasure for me to appear before this distinguished group. The institutions which you represent or serve, which have grown so dramatically in recent years, have as great an interest in the health and well-being of our nation's securities markets as any group in the country.

Indirect investment in securities through institutions is growing at a faster rate than direct investment by members of the public, and private noninsured pension funds have been the fastest growing of the various types of institutions. According to figures which we released earlier this month, the assets of private noninsured pension funds increased by $7.4 billion during 1967 to a total of approximately $72 billion at the year end. Approximately $5.5 billion of this increase represented an increase in holdings of common stock.

Perhaps even more dramatic than the growth in size of pension funds and other institutions in recent years has been the increase in their participation in the equity markets. Other figures we released this month showed that the combined value of common stock transactions in 1967 for four principal classes of financial institutions -- noninsured pension funds, mutual funds, life insurance companies and property and casualty insurance companies -- exceeded $47 billion, an increase of 46% over 1966. By comparison, the dollar volume of all stock transactions on the New York Stock Exchange in 1967 showed a 27% increase over 1966.

The two types of institutions which are currently having the greatest impact on the markets are the pension funds and the mutual funds. But the impact of these two groups is very different. Last year, the pension funds purchased approximately $10.0 billion of common stocks and sold approximately $5.0 billion, meaning that on total transactions of $15.0 billion they made net purchases of $5.0 billion. The mutual funds, on the other hand, purchased approximately $14.9 billion of common stocks and sold approximately $13.3 billion on total transactions of $28.2 billion they made net purchases of $1.6 billion. Thus, while the pension funds provided more than three times as much net buying power to the market as the mutual funds, the mutual funds accounted for almost twice as much overall activity.

While the pension funds had a relatively lower rate of turnover than the mutual funds, their turnover rate still showed a substantial increase over 1966. In fact, all institutions for which we have data, except life insurance companies, had increased turnover rates in 1967. The annual turnover rate of mutual funds was close to 39%, up from approximately 31% in 1966 and 19% in 1965. Pension funds, which had maintained a relatively steady turnover rate between 7 and 8% for the past three years, increased to 11-1/2% in 1967.

As you might imagine, this increased activity of institutional investors in the equity markets, combined with the steady increase in their overall holdings of equity securities, has not gone unnoticed by the Commission and by many others, including members of Congress who serve on committees which have particular responsibility for the securities markets. The actions of the managers of institutional investors, as I have noted on previous occasions, affect many people. They have an obvious and direct effect on the many millions of people who have the ultimate beneficial interest in the pool of assets which the institution represents. Certain relationships of mutual fund managers to their shareholders and the methods of distribution of mutual fund shares are the subjects of legislation introduced last year at our request and currently pending before committees in both Houses of Congress.

The rights of the beneficiaries of pension funds are also the subject of several bills now pending in Congress. Two of the major pension fund bills, now before Congress have been drawn up as the direct outgrowth of deliberations by a special Presidential Committee, on which I have the pleasure of serving. The Committee recognizes that while some of these recommendations -- on disclosure, fiduciary standards, vesting and funding -- are controversial, they represent, in the words used by Labor Secretary Wirtz in submitting the latest set of proposals "a major advance in fulfilling the promise of the private pension system." I want to stress at this point that throughout its deliberations the underlying premise of the Committee has been that it is good public policy to

encourage the growth of private pension plans. There has been no thought of imposing rigid standards which will hinder the continuing healthy growth of these plans. We have been seeking to develop a well-rounded program within which this growing institution will flourish in the decades ahead.

As Chairman of the SEC I have been particularly interested in the legislative proposals requiring disclosure and reporting of financial information and establishment of fiduciary standards. The Commission has gone on record in supporting this proposed legislation, including the addition of a provision which would require the administrator of a plan to publish a brief simplified description of the plans describing participants' benefit rights in readily understandable terms.

The ownership and trading of equity securities by large institutions are also of direct concern to at least two other important groups -- members of the public who invest directly in equity securities, and the companies which issue the securities in which the institutions invest. The relationships and obligations of institutional managers to these two classes has thus far received less attention than their relationships and obligations to their beneficiaries. For these and other reasons, the Commission has supported resolutions which have been introduced in both Houses of Congress authorizing and directing the Commission to undertake an economic study of the impact of institutions on the securities markets, on the process of capital formation and the allocation of savings, and on the control of publicly held corporations.

I testified in support of the Senate resolution at a hearing before the Banking and Currency Committee two weeks ago, which I hope will be a prelude to early Congressional action. The proposed study has also received the support of all segments of the securities industry, as well as representatives of the various classes of institutions which would be the subject of, and would participate in, the study. In this connection, I should note that we anticipate the active assistance and participation of all interested groups in the conduct of the study. We contemplate that the first step in the preparation of the study would be to convene a meeting of representatives of the Commission, of other interested government agencies (such as the Federal Reserve Board), of the self regulatory

bodies, of industry and institutional groups, and distinguished economists, to consider the nature and dimensions of the study, the types of ways of obtaining and analyzing that information. I also contemplate that this group would join us in the creation of an effective advisory committee, representative of the various interests concerned, which would meet regularly with the study staff and with the Commission during and after the completion of the study, and assist us in shaping the scope and conduct of the study.

I believe that the information and understanding which should become available as a result of our proposed study will be of as great, if not greater, benefit to the institutions themselves as to any other group. I am confident that the managers of pension funds, as well as other types of institutions, will cooperate fully with us in developing the necessary information for this study, just as they have cooperated in the more limited stastical and economic studies which we have conducted on a continuing basis in the past. I might mention in this connection that we are still working toward the goal of monthly, rather than quarterly, reports of aggregate data on pension fund investments. This improvement was recommended by a Presidential task force, and we feel it will be helpful to industry and other agencies of the government as well as to the Commission. We are currently working on a reporting form which we hope will meet the government's needs while imposing a minimum burden on the reporting institutions.

I did not come before you this evening only to ask you to do things for us. I also wanted to tell you about a very important endeavor in which we are currently engaged which I hope will result in substantial benefit to you and to the people whom you represent. Your growing significance as investors in equity securities, to which I adverted earlier, is of course accompanied by a corresponding growth in your dependence on the services provided by the brokerage community. In short, institutions are becoming, if not a broker's best friend, at least his best customers.

It has been obvious for some time that the growth in securities trading by institutions, which often follows patterns very different from those followed by individuals in their securities transactions, has placed great strains on the existing compensation structure in the brokerage business, and particularly on the minimum commission rate

structure of the New York Stock Exchange and the other national securities exchanges. The existence of these strains was perhaps most clearly demonstrated by the development of "give-ups" and reciprocal business practices in connection with mutual fund portfolio transactions, by which large portions of the commissions paid on those transactions are diverted to persons who had no connection with the execution of the transaction. It has also stimulated the imagination and the ingenuity of managers of certain institutions to devise various schemes to reduce the actual cost of execution and to spread the excess in a manner which will serve best the interest of the managers. Some have, however, recognized a responsibility to return this excess to the beneficiaries of the institution.

We expressed our concern about these practices to the stock exchanges on a number of occasions, both before and after the issuance of our report on mutual funds in December 1966. In January of this year, the New York Stock Exchange proposed to its members and submitted to us an outline of a plan to modify the commission rate structure and other features of the rules of the various national securities exchanges. To obtain the views of all interested persons, we invited public comment on the very general proposal of the stock exchange, as well as on a proposed Commission rule to deal with the limited problem of give-ups by requiring that all commissions paid to third parties by brokers at the request of the managers of their institutional customers be paid to or credited to the account of the institution.

We received more than two hundred letters of comment on these proposals, from national securities exchanges, from individual broker dealers and their representatives, from certain institutional investors and their representatives, and from the anti-trust division of the Department of Justice. It was apparent to us from these comments that, while there is widespread -- almost universal -- agreement that significant changes must be made in the present structure, the impact of the alternative methods of dealing with the problems would fall very differently on the various interests concerned.

For example, it appears to be generally conceded that lower commissions should be charged on at least the larger transactions of institutional investors. At least three

distinct ways have been suggested to achieve this objective. One suggestion is some type of volume discount in which a fixed, but stepped-down rate would be charged on certain types of transactions or transactions by certain types of institutions.

An alternative suggestion is that there should be no fixed commission rate, at least for large transactions, and that the broker's compensation be the subject of negotiation between him and the customer, either for particular transaction or for his entire business. A third suggestion is that institutions should be permitted to become members of national securities exchanges, thus enabling them to take advantage of the lower inter-member rates which members of those exchanges are permitted to charge one another.

There are of course variations of these and a number of other possibilities, but I mentioned these three only because I am sure you will recognize, simply from my brief description, the great differences in their potential effect on the securities markets, the brokerage business and different groups of institutional customers.

In light of these considerations, the Commission concluded that there is no alternative to holding a public hearing in which we can explore the issues and develop a record on the basis of which we can determine which of the proposed solutions will be fairest to all of the parties concerned.

Accordingly, the Commission announced today that is has issued an order for the institution of an investigation and a public investigatory hearing, pursuant to Section 21(a) of the Securities Exchange Act of 1934 to consider whether any changes should be made in the rules, policies, practices and procedures of registered national securities exchanges respecting commission rate structure.

Information developed by the Commission has led it to conclude that present commission rate structure rules, practices and policies do not, in fact, provide for fixed minimum commission charges on many exchange transactions. As an interim measure the Commission has written a letter to the New York Stock Exchange, pursuant to the provisions of Section 19(b) of the Securities Exchange Act of 1934, specifically requesting it to adopt a revised commission rate schedule which would, among other things, provide for reduced rates for that portion of an order involving round lots in excess of 400 shares or, alternatively, to eliminate requirements for minimum rates of commission for all orders in excess of $50,000. That letter also requests the New York Stock Exchange to implement appropriate reductions in the current intra-member rate for non-executing firms or to eliminate requirements for minimum intra-member charges to such non-executing firms. Letters also have been written to the other registered national securities exchanges suggesting that they consider adopting appropriate interim changes in their rules, practices and policies relating to commission rate structure. These proposed interim changes also will provide a focus for the evidence to be introduced in the public hearing to be held pursuant to Section 21(a).

The order directs that the public hearing will be held in Washington, D. C. commencing on July 1, 1968, and describes in general the matters which will be the subject of the investigation and public hearing. The Commission, in a subsequent release, will describe the procedures to be followed with respect to the hearings.

The investigatory hearing is intended to assist the Commission in the discharge of its responsibility under Section 19(b) of the Exchange Act and other provisions of the securities laws. It is not a substitute for, and its pendency will not preclude, more specific procedures to consider or require specific changes in exchange rules and practices either at the instance of the Commission or at the instance of the exchanges.

Before closing, there is one further point I should like to make in connection with the increasing investment of pension fund assets in equity securities. Many of the workers whose hopes for an adequate retirement income rest on the success of these funds are not only unsophisticated with respect to the intricacies of the equity markets, but may have only the dimmest idea of the extent to which their fortunes are tied in to the vicissitudes of those markets. There is no doubt that, generally speaking, common stocks over the past twenty years have done well. Nevertheless, I believe there are serious potential dangers if people seeking retirement income are led to believe that investments in common stocks are essentially equivalent to fixed income securities, but simply offer a much higher rate of return. It may be difficult for some of us to recall, but stock prices can go down as well as up, and I do not believe any of you would relish the prospect of explaining to the participants in a plan, who had not been led to anticipate any such result, how their carefully accumulated pension rights had suddenly become worthless, or considerably diminished in value.

I am particularly concerned at recent indications that the so-called "performance fad" may be spreading to pension funds from other types of investment media. While short-term trading may have its place for certain types of investors, and may under certain circumstances have a constructive influence on the market, it would hardly seem to be the natural activity for those entrusted with the savings of people whose investment goals are measured in decades rather than weeks or months and who may have little or no control over the timing of their retirement. Moreover, if current proposals for early vesting, for portability, and for more effective funding eventuate, the relevant considerations would undoubtedly become more critical in this area.

In closing, let me say simply that I am sure you all recognize the enormous responsibilities that your power over the securities markets and the welfare of your plan participants entails, and I know that you will continue to make a notable contribution to the well-being of our securities markets and of the beneficiaries who rely on your judgment.