OVER-THE-COUNTER MARGIN REGULATIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON COMMERCE AND FINANCE

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE HOUSE OF REPRESENTATIVES

NINETIETH CONGRESS

SECOND SESSION

ON

H.R. 7696

A BILL TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO PERMIT REGULATION OF THE AMOUNT OF CREDIT THAT MAY BE EXTENDED AND MAINTAINED WITH RESPECT TO SECURITIES THAT ARE NOT REGISTERED ON A NATIONAL SECURITIES EXCHANGE

H.J. Res. 946

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO AUTHORIZE AN INVESTIGATION OF THE EFFECT ON THE SECURITIES MARKETS OF THE OPERATION OF INSTITUTIONAL INVESTORS

JUNE 21, 1968

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OVER-THE-COUNTER MARGIN REGULATIONS

FRIDAY, JUNE 21, 1968

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 2123, Rayburn House Office Building, Hon. John E. Moss (chairman of the subcommittee) presiding.

Mr. MOSS. The Subcommittee on Commerce and Finance is meeting this morning for the purpose of conducting hearings on two measures, the first being H.R. 7696, a bill introduced by Chairman Staggers at the request of the Federal Reserve Board, and the other being House Joint Resolution 946, jointly introduced by Mr. Keith and myself.

H.R. 7696 would permit the imposition by the Federal Reserve Board of margin requirements, to the extent appropriate, on credit granted by banks and other lenders for the purpose of purchasing and carrying the more widely held and actively traded over-the-counter securities.

In a letter to the committee of June 13, the Federal Reserve Board stresses its belief that current developments in the securities markets reinforces the need for early legislative attention to closing the present serious gap in the effectiveness of the Board's regulations in preventing excess use of credit in the securities markets.

House Joint Resolution 946 was introduced by Mr. Keith and myself last December, following hearings which this committee had on H.R. 9510 and H.R. 9511, bills embodying the legislative program of the Securities and Exchange Commission for providing additional protection to security holders of investment companies.

As we stated at the time that we introduced this resolution, it was clear that within the last few years there has been tremendous growth in the holdings of securities by institutional investors which raises numerous questions about the effect of this institutionalization of the markets on our auction markets as we have known them.

Traditionally, they have been geared to a steady flow of relatively small orders from a multitude of individual investors who buy and sell for a variety of reasons. Institutionalization means not only a trading in large blocks but may also mean that we cannot have an auction market comprised of numerous free buyers and sellers. The fact that more than one-third, perhaps two-fifths, of all trading today is the result of institutional buying and selling is something whose effect we cannot fully appreciate.

The institutionalization of investments has implications which go beyond the functioning of the market, itself, for the large institutional holdings in the stock of many companies raises questions as to the relationship between institutional investors and the managements of publicly held companies as well as possible problems as to the concentration of influence, if not control, of significant segments of American industry.

It seems clear that we do not know enough about this institutionalization. The phenomenon while commented upon in the Wharton Study and in the SEC Study is recently of such dramatic proportions that it simply was not considered in the legislative recommendations proposed by the Commission some months back.

The events of the last few months, indeed the last few weeks, cannot but enhance the need for the launching of a study of this character.

Mr. Keith, do you have a statement?

Mr. KEITH. I would just second what you have said, Mr. Chairman.

I concur that the urgency is even greater than it was a year ago when Mr. Martin said the activity of the institutional investor contained possible news qualities reminiscent in some respects of the 1920's. If it is true in May 1967, certainly it is true in June of 1968.

I would hope that we would act favorably on this resolution and that a study get underway so that it will shed some light on problems that are most important and most significant at this time.

Mr. MOSS. Thank you.

At this point in the record we will include the text of the legislation under consideration, and agency reports thereon.

(H.R. 7696 and departmental reports thereon follows:)

[H.R. 7696, 90th Cong., first sess.]

A BILL To amend the Securities Exchange Act of 1934 to permit regulation of the amount of credit that may be extended and maintained with respect to securities that are not registered on a national securities exchange

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 7 of the Securities Exchange Act of 1934 (15 U.S.C. 78g) is amended—

(1) by striking out "registered on a national securities exchange" in subsection (a);

(2) by amending subsection (c) to read as follows:

"(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

"(1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section;

"(2) without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board of Governors of the Federal Reserve System may prescribe (A) to permit under specified conditions and for a limited period any such member, broker, or dealer to maintain a credit initially extended in conformity with the rules and regulations of the Board of Governors of the Federal Reserve System, and (B) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection."

(3) by striking out "registered on a national securities exchange" in the first sentence of subsection (d) and "registered on national securities exchanges" in the second sentence of that subsection.

EXECUTIVE OFFICE OF THE PRESIDENT,
BUREAU OF THE BUDGET,
Washington, D.C., May 15, 1968.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the views of the Bureau of the Budget on H.R. 7696, a bill "To amend the Securities Exchange Act of 1934 to permit regulation of the amount of credit that may be extended and maintained with respect to securities that are not registered on a national securities exchange."

The bill would remove the present prohibition on the extension of credit by brokers and dealers for the purchase of securities traded in the over-the-counter market, and would make all loans by these and other lenders which are secured by such over-the-counter collateral subject to the same regulatory authority of the Board of Governors of the Federal Reserve System which currently applies to credit on securities registered on a national securities exchange.

The legislation would carry out one of the major recommendations of the Special Study of Securities Markets conducted by the Securities and Exchange Commission in 1963 and is strongly supported by both the Commission and the Federal Reserve Board. The Bureau of the Budget concurs with these agencies in recommending enactment of H.R. 7696.

Sincerely yours,

WILFRED H. ROMMEL,
Assistant Director for Legislative Reference.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., May 16, 1968.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is in response to your request of March 24, 1967 for our views on H.R. 7696, which would amend Section 7 of the Securities Exchange Act of 1934 to authorize the Federal Reserve Board to extend margin regulation to over-the-counter securities.

The Act presently restricts broker-dealers from extending credit on any securities traded in the over-the-counter market and allows banks to lend on such securities without restriction. The legislation would (1) put non-exempt over-the-counter securities in the same status as exchange-listed securities for margin purposes, i.e., permit broker-dealers to extend credit on these over-the-counter securities subject to Board rules and regulations, and (2) restrict banks from extending credit for these securities in amounts greater than the applicable margin rates.

The Commission generally supports the proposed amendment to Section 7 of the Exchange Act. We believe, however, that in implementing the proposal, the availability of margin by broker-dealers should be restricted as discussed below.

We suggest that margin credit extended by broker-dealers be limited to the securities of those companies publicly reporting financial information, the markets for which have a reasonable amount of depth and liquidity as measured by public and dealer interest. By establishing minimum criteria with respect to issuers and the market for their securities, such as net assets, number of shareholders, number of shares outstanding, and number of market makers over a period of time, it is possible to derive a category of over-the-counter securities appropriate for margin regulation. As the purpose of the legislation is to give the Board general authority to extend margin coverage to the over-the-counter market, we do not feel that it is necessary at this time to develop specific standards for determining margin eligibility.

We feel that the proposal will remove an anomaly in our credit regulation and will provide a useful credit and merchandising tool if the categories of issuers and brokers are sufficiently limited.

Sincerely,

MANUEL F. COHEN, *Chairman.*

THE GENERAL COUNSEL OF THE TREASURY,
Washington, D.C., May 16, 1968.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Reference is made to your request for the views of this Department on H.R. 7696, "To amend the Securities Exchange Act of 1934 to permit regulation of the amount of credit that may be extended and maintained with respect to securities that are not registered on a national securities exchange."

Section 7 of the Securities Exchange Act of 1934 gives to the Board of Governors of the Federal Reserve System the authority to regulate the amount of credit that brokers and dealers may extend on securities registered on a national securities exchange. Section 7 prohibits dealers and brokers from granting credit on securities not so listed (over-the-counter securities) but does allow banks to grant credit on such unlisted securities on such terms as they deem appropriate. The proposed legislation would amend section 7 of the Securities Exchange Act by granting authority to the Board of Governors to establish and regulate margin requirements applicable to brokers and banks on unlisted securities.

The effect of the bill would be to permit brokers and dealers for the first time to extend credit on unlisted securities in accordance with regulations of the Board of Governors and to carry such unlisted securities in the general accounts of their clients. Similarly, the regulations of the Board to be adopted under the bill would apply to the extension of credit by banks on unlisted as well as listed securities.

The extension of the present lending restrictions on listed stock collateral to all stock collateral would raise some difficult problems for banks. Banks lend on the collateral of unlisted securities for many purposes other than to finance the purchase of such securities. A businessman may pledge shares in his own closely held company when borrowing for normal business purposes. It would be difficult to distinguish this type of loan from one identical in form but where the ultimate purpose was for speculation in the securities markets. These difficulties of differentiating so-called "non-purpose" loans already inherent in enforcing Regulation "U" would be multiplied many times if the law were extended to all OTC securities.

However, we recognize the illogic of the present situation wherein an investor wanting to buy 100 shares that are registered on a national securities exchange may borrow only 30% of the purchase price, but if he wishes to purchase 100 shares of an OTC issue he can borrow 60%, 70% or whatever a lender is willing to lend on such collateral. It appears clear that the purpose of the proponents is to equalize this situation and not to reach loans secured by stock of closely held corporations.

We believe that the purposes of the legislation would be achieved without creating the difficulties for banks described above if the same tests for coverage used in the Securities Acts Amendments of 1964 were adopted. The purposes of the 1964 amendments were very similar to H.R. 7696, i.e., to bring actively traded OTC securities within certain provisions of the Securities Act of 1933 and the Exchange Act of 1934. We note that the Board of Governors, in its letter transmitting the draft legislation to the Congress, indicates that it plans to issue regulations establishing standards similar to those provided in the Securities Acts Amendments of 1964.

In view of the above, the Department would have no objection to the proposed legislation.

The Department has been advised by the Bureau of the Budget that there is no objection from the standpoint of the Administration's program to the submission of this report to your Committee.

Sincerely yours,

FRED B. SMITH, *General Counsel.*

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., April 12, 1967.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: You have asked for a report on H.R. 7696, a bill to amend the Securities Exchange Act of 1934 to permit regulation of the amount of credit that may be extended and maintained with respect to securities that are not registered on national securities exchange. As you will recall, this bill is identical with draft legislation submitted by the Board of Governors. The considerations which the Board believes support enactment of this legislation are outlined in my letter to you of March 1, 1967. A copy is enclosed for your convenient reference.

Sincerely yours,

WM. McC. MARTIN, Jr., *Chairman.*

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., March 1, 1967.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Section 7 of the Securities Exchange Act of 1934 (15 U.S.C. 78g) authorizes the Board of Governors to regulate (1) credit that brokers and dealers may extend on securities registered on an exchange, and (2) credit that banks (and other lenders) may extend for the purpose of purchasing or carrying securities registered on an exchange. The Act, while prohibiting brokers and dealers from extending credit on securities traded not on exchanges but "over the counter" ("OTC"), allows banks to lend without restriction where the purpose is to buy or carry OTC securities. In other words, while brokers and dealers are prohibited from lending at all on OTC securities, bank credit to buy such securities, and secured thereby, may be extended in uncontrolled amounts. The Board has favored readjustment of the law so that actively-traded OTC securities could be placed more nearly on the same basis, in this respect, as exchange-registered securities (see, for example, the enclosed excerpt from the *Annual Report of the Board of Governors for 1964*).

As reported in Chapter X of the Securities and Exchange Commission's special Study of the Securities Market, H.R. Doc. No. 95, 88th Cong. (1963), the OTC market has in part developed sufficiently to make it unreasonable to continue the existing difference in the status, for this purpose, of widely-held OTC securities and securities registered on an exchange. In other words, trading in certain OTC securities has become a significant factor in the securities market, and their present exclusion from margin-regulation coverage represents a serious gap in the effectiveness of the Board's regulations in preventing excessive use of credit to purchase and carry securities.

The statutory amendments embodied in the enclosed draft bill would not directly affect the present scheme of securities market credit controls; they would simply authorize the Federal Reserve Board to encompass OTC securities within the Federal security-credit regulations. If the proposed bill were enacted, present regulations would continue to operate as they do now, and the Board could proceed in an orderly way to bring specified categories of OTC securities under margin requirements to the extent that appears to be appropriate and feasible.

The majority of OTC securities are not actively traded and, therefore, are not suitable for margin regulation. At present, of the 20,000 securities traded over the counter price quotations are disseminated to the public for about 1200 issues. Even within this group, many issues do not have the depth of market,

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public information, or the investor interest requisite to permit trading in a margin account. Accordingly, if this legislation is adopted, the Board presently contemplates issuance of regulations that would apply to those securities that (1) are subject to public disclosure requirements under the 1964 Securities Acts Amendments, and (2) are traded in sufficient volume to assure reliable pricing, reasonable liquidity, and substantial investor and dealer interest.

Of course, development of specific objective tests to ascertain which OTC securities meet these standards is one of several problems that would be encountered in the exercise of this new authority. Those problems, the Board believes, could best be handled by regulation, after publication of proposed regulations would elicit the views and criticism of the investing public and the securities industry.

The Securities and Exchange Commission has reviewed this proposal and supports it. The Commission believes that the regulations should be limited, at least initially, to OTC stocks which meet whatever criteria may be established, such as those set out above, and that dealers who maintain inventories and make markets in a particular security should be restricted in their ability to sell such securities on margin because of the conflicts of interest inherent in such situations. The Commission has offered to aid in the development of appropriate regulations.

The Board recommends the introduction and favorable consideration of the enclosed draft bill. Also enclosed is a markup of the present statute, indicating the proposed changes in existing law.

Sincerely yours,

WM. McC. MARTIN, Jr., *Chairman.*

EXCERPT FROM 1964 ANNUAL REPORT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (P. 207)

Margin requirements for securities transactions. Section 7 of the Securities Exchange Act of 1934 (15 U.S.C. 78g) authorizes the Board of Governors to limit the credit that brokers and dealers may extend on securities that are registered on a national securities exchange and to limit the credit that banks (and other lenders) may extend for the purpose of purchasing or carrying equity securities that are so registered. However, with respect to securities that are not traded on exchanges but only "over the counter," that Act forbids brokers and dealers, generally speaking, to extend any credit whatever, and permits banks to extend credit without being subject to any governmentally-imposed margin requirements.

For many years the Board has favored amendment of the law in this area. The present arrangement is inequitable in its contrasting treatment of brokers and banks. In addition it limits the effectiveness of salutary controls over security credit and unnecessarily deprives over-the-counter securities of credit facilities that might appropriately be extended by brokers and dealers. The growth of the over-the-counter securities market has given this problem increased importance, and the Securities and Exchange Commission's *Special Study of Securities Markets*, a report made to Congress in 1963, recommended amendment of the 1934 Act in these respects.

The Board urges enactment of legislation modifying Section 7 of that Act to eliminate this unwarranted difference in the status, for credit purposes, of securities traded on exchanges and securities traded over the counter.

SECTION 7 OF THE SECURITIES EXCHANGE ACT MARKED TO INDICATE CHANGES THAT WOULD BE MADE BY AMENDMENTS PROPOSED BY BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Section 7. (a) For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall, prior to the effective date of this section and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security). For the initial extension of credit, such rules and regulations shall be based upon the following standard: An amount not greater than whichever is the higher of—

(1) 55 per centum of the current market price of the security, or

(2) 100 per centum of the lowest market price of the security during the preceding thirty-six calendar months, but not more than 75 per centum of the current market price.

Such rules and regulations may make appropriate provision with respect to the carrying of undermargined accounts for limited periods and under specified conditions; the withdrawal of funds or securities; the substitution or additional purchases of securities; the transfer of accounts from one lender to another; special or different margin requirements for delayed deliveries, short sales, arbitrage transactions, and securities to which paragraph (2) of this subsection does not apply; the bases and the methods to be used in calculating loans, and margins and market prices; and similar administrative adjustments and details. For the purposes of paragraph (2) of this subsection, until July 1, 1936, the lowest price at which a security has sold on or after July 1, 1933, shall be considered as the lowest price at which such security has sold during the preceding thirty-six calendar months.

(b) Notwithstanding the provisions of subsection (a) of this section, the Board of Governors of the Federal Reserve System may, from time to time, with respect to all or specified securities or transactions, or classes of securities, or classes of transactions, by such rules and regulations (1) prescribe such lower margin requirements for the initial extension or maintenance of credit as it deems necessary or appropriate for the accommodation of commerce and industry, having due regard to the general credit situation of the country, and (2) prescribe such higher margin requirements for the initial extension or maintenance of credit as it may deem necessary or appropriate to prevent the excessive use of credit to finance transactions in securities.

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

(1) On any security (other than an exempted security) in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section.

(2) Without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board of Governors of the Federal Reserve System may prescribe (A) to permit under specified conditions and for a limited period any such member, broker, or dealer to maintain a credit initially extended in conformity with the rules and regulations of the Board of Governors of the Federal Reserve System, and (B) to prmit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection.

(d) It shall be unlawful for any person not subject to subsection (c) of this section to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security, in contravention of such rules and regulations as the Board of Governors of the Federal Reserve System shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section. Such rules and regulations may impose upon all loans made for the purpose of purchasing or carrying securities limitations similar to those imposed upon members, brokers, or dealers by subsection (c) of this section and the rules and regulations thereunder. This subsection and the rules and regulations thereunder shall not apply (A) to a loan made by a person not in the ordinary course of his business, (B) to a loan on an exempted security, (C) to a loan to a dealer to aid in the financing of the distribution of securities to customers not through the medium of a national securities exchange, (D) to a loan by a bank on a security other than an equity security, or (E) to such other loans as the Board of Governors of the Federal Reserve System shall, by such rules and regulations as it may deem necessary or appropriate in the public interest or for the protection of investors, exempt, either unconditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection and the rules and regulations thereunder.

(e) The provisions of this section or the rules and regulations thereunder shall not apply on or before July 1, 1937, to any loan or extension of credit made prior to the enactment of this title or to the maintenance, renewal, or extension of any such loan or credit, except to the extent that the Board of Governors of the Federal Reserve System may by rules and regulations prescribe as necessary to prevent the circumvention of the provisions of this section or the rules and regulations thereunder by means of withdrawals of funds or securities, substitutions of securities, or additional purchases or by any other device.

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., June 13, 1968.

Hon. HARLEY O. STAGGERS,
Chairman, Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In the course of reaching its decision to raise margin requirements on listed securities on June 7, 1968, the Board of Governors also viewed with concern recent developments with respect to equity securities traded over the counter which the Board has no authority to subject to its margin regulations. All of the available indicators of over-the-counter securities market performance appear to suggest substantial speculative activity, partly credit-financed, which reemphasizes the need for appropriate legislative action in this area.

As you will recall the Board has recommended to the Congress and you have introduced a bill H.R. 7696 to permit imposition of margin requirements, to the extent appropriate, on credit granted by banks and other lenders for the purpose of purchasing and carrying the more widely held and actively traded over-the-counter securities. Enactment of such legislation is needed to close a serious gap in the effectiveness of the Board's regulations in preventing excessive use of credit in the securities markets. The Board believes that current developments in those markets serve to reinforce the need for early legislative attention to this problem. The Board hopes for an early opportunity to testify before your Committee on the desirability of such legislation.

Sincerely,

J. L. ROBERTSON,
Vice Chairman.

(H.J. Res. 946 and departmental reports thereon follows:)

[H.J. Res. 946, 90th Cong., first sess.]

JOINT RESOLUTION To amend the Securities Exchange Act of 1934 to authorize an investigation of the effect on the securities markets of the operation of institutional investors

Whereas there has been a very significant increase in the amount of securities held and traded by institutional investors both in absolute terms and in relation to other types of investors; and

Whereas such an increase may have an impact upon the maintenance of fair and orderly securities markets, upon the issuers of securities traded in such markets, and upon the interests of investors and the public interest: Now, therefore, be it

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled, That section 19 of the Securities Exchange Act of 1934 is amended by adding at the end thereof the following:

"(e) The Commission is authorized and directed to make a study and investigation of the purchase, sale, and holding of securities by institutional investors of all types including, but not limited to, banks, insurance companies, mutual funds, employee pension and welfare funds, foundation and college endowments, in order to determine the effect of such purchases, sales, and holdings upon the maintenance of fair and orderly securities markets and upon the stability of such markets, both in general and for individual securities, and upon the interests of the issuers of such securities, and upon the interests of the public so that the Congress may determine what measures, if any, may be necessary and appropriate in the public interest and for the protection of investors. The Commission shall report to the Congress on or before January 20, 1969, the results of its study and investigation, together with its recommendations, including such recommendations for legislation as it deems advisable. For the purposes of the study and investigation authorized by this subsection the Commission shall have all the power and authority which it would have if such investigation were being conducted pursuant to section 21 of this Act. The Commission is authorized to appoint, without regard to the provisions of title 5, United States Code, governing appointments in the competitive service, and to pay, without regard to the provision of chapter 51 and subchapter III of chapter 53 of such title relating to classification and General Schedule pay rates, such personnel as the Commission deems advisable to carry out the study and investigation authorized by this subsection, but no such rate shall exceed the per annum rate in effect for a GS–18. For the purposes of this subsection, there is authorized $____________."

EXECUTIVE OFFICE OF THE PRESIDENT,
BUREAU OF THE BUDGET,
Washington, D.C., June 26, 1968.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the views of the Bureau of the Budget on H.J. Res. 946, a resolution "To amend the Securities Exchange Act of 1934 to authorize an investigation of the effect on the securities markets of the operation of institutional investors."

The resolution would direct the Commission to study the purchase, sale, and holding of securities by institutional investors of all types. The purpose of the study is to determine the effect of such activities upon the maintenance of fair and orderly securities markets, the stability of such markets, the interests of the issuers of such securities, and the interests of the public.

The resolution being considered by your committee leaves blank the maximum amount of the appropriations which would be authorized for the study, but the companion resolution passed by the Senate (S.J. Res. 160) authorizes appropriations of $875,000. In any event, the actual appropriations which would be subsequently requested by the President would be determined only after review of the specific requirements for the study and in the context of the overall budget constraints.

We also note that H.J. Res. 946 would require a report by SEC to the Congress by January 20, 1969, and agree with the Commission's view that this date would represent too tight a time schedule and that a longer period for the study would be desirable.

Subject to these comments, the Bureau of the Budget would have no objection to the enactment of H.J. Res. 946.

Sincerely yours,

WILFRED H. ROMMEL,
Assistant Director for Legislative Reference.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., January 16, 1968.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reply to your recent letter requesting a report with respect to H.J. Res. 946.

This resolution would authorize and direct the Commission to make a study and investigation of the purchase, sale and holding of securities by institutional investors of all types and would require the Commission to report to the Congress on or before January 20, 1969 the results of its study and investigation together with its recommendations.

In the course of my testimony at the hearings on H.R. 9510 and H.R. 9511 before the Subcommittee on Commerce and Finance of your Committee, I testified, in response to questions from members of the Subcommittee, that a study along the lines proposed in H.J. Res. 946 is not only desirable but necessary. As the proposed resolution recognizes, the great increase in the amount of securities held and traded by institutional investors both in absolute terms and in relation to the activity of other investors, may have an important impact upon the securities markets, the issuers of securities traded in such markets and the public interest and, as was pointed out in the Special Study of Securities Markets, the available information with respect to institutional investment is both incomplete and inadequate.

We note that the proposed resolution does not specify the amount authorized to be appropriated nor does it authorize the Commission to accept donations from private sources for purposes of the study. As I am sure you will recognize, in view of the current policies of the Bureau of the Budget and of the Congress with respect to the reduction of expenditures, it would be extremely difficult for us to make any such study without substantial additional funds. We realize that both the authors of the resolution and your Committee are aware of this and we anticipate that if the resolution is to be enacted, the necessary financing arrangements would be made.

In my answers to questions with respect to this matter by the Subcommittee members, I pointed out that the proposed study might well underscore the need for arrangements to provide a continuing flow of information with respect to the activities of institutional investors, so that informed decisions may be made not only as a result of the study but in the future as well. These arrangements may require further legislation, since I understand that it is considered inappropriate to provide permanent procedures for the collection of information on this subject in a joint resolution.

We also note that the resolution requires the Commission to report the results of its study to the Congress by January 20, 1969. We feel that even if the study is authorized early in the current session, the time required to organize and staff the study, in addition to that required for its actual conduct, would make it unlikely that the study could be completed before June 30, 1969. We therefore suggest that the deadline for completion of the study be changed to a later date.

I would also like to emphasize our strong agreement with the comment made by Congressman Moss when he introduced H.J. Res. 946, which comment appears in the Congressional Record for December 2, 1967 at page H 16243, that the resolution and the study provided for therein, "are not intended as a substitute for, or as a prerequisite to, the legislative proposals contained in H.R. 9510 and 9511."

In conclusion, we support H.J. Res. 946. We hope that necessary arrangements, particularly with respect to financing, will be made.

Sincerely,

MANUEL F. COHEN, *Chairman.*

THE GENERAL COUNSEL OF THE TREASURY,
Washington, D.C., June 21, 1968.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Reference is made to your request for the views of this Department on H.J. Res. 946, "To amend the Securities Exchange Act of 1934 to authorize an investigation of the effect on the securities markets of the operation of institutional investors."

The proposed legislation would authorize and direct the Securities and Exchange Commission to conduct a study of the impact of institutional investors on various operations of the securities markets.

The Department would have no objection to the proposed legislation.

The Department has been advised by the Bureau of the Budget that there is no objection from the standpoint of the Administration's program to the submission of this report to your Committee.

Sincerely yours,

FRED B. SMITH, *General Counsel.*

DEPARTMENT OF LABOR,
Washington, D.C., June 25, 1968.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reply to your request for my views on H.J. Res. 946, "To amend the Securities Exchange Act of 1934 to authorize an investigation of the effect on the securities markets of the operation of institutional investors."

There has been a significant increase in the amount of securities held and traded by institutional investors, including pension and welfare plans. Therefore, the proposed study concerning the effect of this activity would appear to be timely and useful, and I endorse the Resolution.

The Bureau of the Budget advises that there is no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

WILLARD WIRTZ,
Secretary of Labor.

DEPARTMENT OF JUSTICE,
Washington, D.C., June 21, 1968.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the views of the Department of Justice on H.J. Res. 946, a resolution "To amend the Securities Exchange Act of 1934 to authorize an investigation of the effect on the securities markets of the operation of institutional investors."

The resolution would amend section 19 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 77(b), *et seq.*, which gives the Commission broad disciplinary powers over exchanges and securities for the protection of investors. Included is the authority to suspend or expel national securities exchanges or registered securities and to suspend trading in any registered security or to suspend all trading on any nationwide securities exchange, for limited periods, in the public interest. Also authorized are studies and investigations of the adequacy of the rules of national securities exchanges and national securities associations.

Under this proposal the Commission would be authorized to study and investigate the purchase, sale, and holding of securities by institutional investors of all types including, but not limited to, banks, insurance companies, mutual funds, employee pension and welfare funds and foundation and college endowments. The purpose of the study is to ascertain the effect of such transactions upon the stability and orderly maintenance of security markets and upon the issuers of securities traded in such markets. The study would determine the nature of any measures needed to protect investors and serve the public interest.

The Department of Justice favors the enactment of legislation authorizing this study. The maintenance of stable securities markets and the safeguarding of our market economy from severe changes insure its capacity for sustained growth and development. The proposed study would enable the Commission to assess the enormous impact of institutional investors upon securities markets and to propose whatever legislation may be needed for effective Commission regulation.

The Bureau of the Budget has advised that there is no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

WARREN CHRISTOPHER,
Deputy Attorney General.

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., January 16, 1968.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the Board's comments on H.J. Res. 946, a resolution authorizing an investigation of the effect on the security markets of the operation of institutional investors. The Board endorses the proposal to study this important aspect of the functioning of our financial system.

In recent decades, financial intermediaries have developed into a major conduit for channeling the flow of funds in the United States economy, and this development has made a significant contribution to the efficiency with which the financial savings of the public is made available for the financing of economic growth. At the same time, however, the increasing importance of intermediaries has had significant implications for the functioning of securities markets, raising questions as to whether the practices and rules developed in an era when financial markets were characterized by many individual buyers and sellers continue to be appropriate. Some of these questions have particular relevance to the responsibilities of the Federal Reserve System: for example, have the activities of institutional investors introduced new elements of instability in financial markets? Have the market activities of institutional investors tended to moderate or aggravate the fluctuations in securities prices? Has the increased importance of institutional investors reduced or otherwise modified the role of credit in supporting speculative activity in financial markets?

The Board's staff has been working with the staff of the Securities and Exchange Commission on the design of a study which would be addressed to answering these and other significant questions on institutional investor activity, and we will be glad to continue to cooperate with SEC in this connection.

Sincerely yours,

WM. MCC. MARTIN, Jr., *Chairman.*

COMPTROLLER GENERAL OF THE UNITED STATES,
Washington, D.C., January 30, 1968.

Hon. JOHN E. MOSS,
Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In response to your request of December 12, 1967, and our subsequent discussion with Mr. John Billett of your staff, we have reviewed the estimated budget prepared by the Securities and Exchange Commission for accomplishing the provisions of House Joint Resolution 946. This proposed resolution would authorize and direct the Commission to conduct a study and investigation of the effect of the purchase, sale, and holding of securities by institutional investors upon the maintenance of fair and orderly securities markets and upon the stability of such markets. The resolution also provides that the Commission will report to the Congress on or before January 20, 1969, the results of its study and investigation, together with its recommendations, including such recommendations for legislation as it deems advisable.

The budget prepared by the Commission presents an estimate of $875,000 for performing the study and investigation. The estimate consists of $702,800 for the salaries of a staff of 75 employees, and $172,200 for travel, personnel benefits, and the other types of expenses likely to be incurred. The budget does not contain estimates identified as being for contingencies.

The staffing plan developed by the Commission was based on its general knowledge of securities markets, its prior experience in conducting studies and investigations, and its judgment of the numbers and types of technical and supporting personnel required to perform the work necessary to meet the purposes and objectives of the study and investigation.

We note that the estimated salaries are based on obtaining the staff of 75 in four increments, the first increment of 18 professional employees and 5 secretaries to be assigned to the work on February 15, 1968, and the remaining 52 employees to be assigned in three increments between March 1 and June 30, 1968. In the event that appropriations for the study and investigation are not made by February 15, 1968, or if appropriations are timely made, but the Commission is not able to obtain the expected staff members on that date and the other planned dates, then either the estimated budget for salaries would be in excess of actual expenditures or the planned level of staffing would have to be increased if the overall man-days budgeted are needed in full and if the job is to be completed within the allotted time. We note that the Chairman of the Commission expressed to you his doubts that the work can be completed within the allotted time period and his belief that, if the time is extended, some adjustment of the budget will be necessary.

The salary estimates for the 75 personnel are based on the salary rates at the minimum pay level of the applicable grades. If the Commission were to assign some of its own staff or obtain other Federal employees for the study and investigation, it is quite possible that some of this staff would be in pay grade steps higher than the minimum step of the grade. Also, the Commission has not given effect in the budget estimates to the minimum 3 percent pay increase which, under present legislation, will become effective in July 1968. However, these considerations appear to have no major effect on the estimates.

As previously noted, the major portion of the budget estimate, about $700,000, is for salaries of personnel; the Commission bases its judgment of this need on its general experience and expertise. We have no specialized information or other knowledge on which we can base an evaluation of the reasonableness of the proposed total man-day requirements underlying this portion of the budget estimate. The remainder of the budget estimate for travel, personnel benefits, and other expenses, appears reasonable on the basis of the data supporting this amount and on the basis of the Commission's planned level and pattern of staffing.

We trust that the foregoing information will be of assistance to you.

Sincerely yours,

ELMER B. STAATS,
Comptroller General of the United States.

Mr. MOSS. Our first witness will be the Honorable Manuel F. Cohen, Chairman of the Securities and Exchange Commission.

Mr. Chairman, we are pleased to welcome you here this morning. You may, if you desire, file your statements for the record and summarize them, or you may read them verbatim.

STATEMENT OF HON. MANUEL F. COHEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY WALTER NORTH, ASSOCIATE GENERAL COUNSEL; AND LAUGHLIN McHUGH, CHIEF, ECONOMIST

Mr. COHEN. Thank you, Mr. Chairman.

Accompanying me are Mr. Walter North, our associate general counsel, and Mr. Laughlin McHugh, our chief economist, and other members of the staff, in the event that the committee may have some questions that I may not be able to deal with effectively.

I do have a short statement with respect to H.R. 7696 which relates to an amendment of section 7 of the Exchange Act, to authorize the Federal Reserve Board to extend margin regulations to over-the-counter securities.

The Federal Reserve Board and the Commission, or at least our staffs, have explored the possibilities and the problems. I think we do have an understanding of these matters and there is the greatest cooperation between us with respect to dealing with them.

With your permission, I will submit the statement for the record.

Mr. MOSS. Without objection, the statement is received for the record at this point.

(Mr. Cohen's prepared statement on H.R. 7696 follows:)

STATEMENT OF HON. MANUEL F. COHEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ON H.R. 7696

Mr. Chairman and members of the subcommittee, my name is Manuel F. Cohen, Chairman of the Securities and Exchange Commission. I am pleased to testify today on H.R. 7696 which would amend Section 7 of the Securities Exchange Act of 1934 to authorize the Federal Reserve Board to extend margin regulation to over-the-counter securities.

The Act presently restricts broker-dealers from extending credit to purchase or carry securities traded in the over-the-counter market and allows banks to lend on such securities without restriction. The proposed legislation would accomplish two ends. First of all, the amendment would put over-the-counter securities in the same status as exchange listed securities for margin purposes; that is, it would permit broker-dealers to extend credit on over-the-counter securities subject to Federal Reserve Board rules and regulations. Secondly, it would permit the Board to restrict the extension of credit for the purchase of over-the-counter securities in amounts greater than the applicable margin rates as the Board now does as to listed securities only. The Commission favors adoption of the proposed amendment.

In 1963, the Report of the Special Study of Securities Markets recommended the legislation envisioned by House Bill 7696. The Special Study found that the distinction in treatment afforded by the 1934 Act to listed stocks as opposed to over-the-counter stocks was based primarily on the lack of reliable, current price information and on the presumed illiquidity of over-the-counter issues as they relate to the different economic functions served by bank and broker credit. As the Special Study pointed out, these conditions have changed since 1934, particularly in view of the increased disclosure and more reliable quotations for many over-the-counter securities contemplated by the Securities Act Amendments of 1964. A good many securities traded in the over-the-counter market are, however, clearly not suitable for margin credit. Accordingly, we believe that in implementing the proposal, the availability of credit from broker-dealers could be restricted by the Federal Reserve Board to the securities of companies publicly reporting adequate financial information and enjoying markets with reasonable depth and liquidity as measured by public and dealer interest. By establishing minimum criteria with respect to issuers and the markets for their securities, such as a reasonable minimum of net assets, number of shareholders, number of shares outstanding and number of marketmakers over a period of time, it would be possible to develop standards as to over-the-counter securities to which it would be appropriate for brokers to extend margin.

Historically, the Board of Governors of the Federal Reserve System has had primary responsibility for the regulation of security credit in relation to monetary control and the entire ceonomy. The Commission, on the other hand, has had the responsibility to enforce these controls but only as it related to security credit and then only to the extent that it is a factor in the regulation of securities markets. As the purpose of the legislation is to give the Board general authority to extend margin regulation to the over-the-counter market, we do not feel that it is necessary at this time to develop specific standards for determining the conditions under which brokers might extend margin. The necessary standards can be developed by the Federal Reserve Board with the Commission's cooperation and assistance.

It is our understanding that banks today finance marketmakers with loans equal to 80 to 90% of the value of the securities pledged. In light of the important role performed by bona fide marketmakers in providing reasonably continuous over-the-counter markets, we believe that in the implementation of the proposed amendment, the advisability of providing an exemption similar to that currently available to specialists on national securities exchanges under Regulation U should be seriously considered by the Federal Reserve Board for those dealers who maintain and make bona fide over-the-counter markets.

In short, we feel that the proposal would remove an anomaly in credit regulation, open up an additional area of margin authority to brokers and would provide a useful credit control tool.

Mr. Cohen. Now I have a somewhat longer statement dealing with H.J. Res. 946, the institutional investor study. Perhaps to this committee it may be belaboring the obvious but, with your permission, I would like to deal with it a little more fully because we share with you, as does every responsible element in the securities industry and in the institutions, a great concern or at least a tremendous interest in developing all relevant information so that we can present to you information which will enable you to arrive at an appropriate conclusion with respect to legislative questions if that seems appropriate, or other solutions which may seem to be warranted.

I do want to emphasize two points, if I may, before I start, although it is contained in my statement and before I am through I may wish to submit that statement as well.

I should say that full credit for the interest, the great public interest, in this matter is really due to this committee. Of course, this committee is aware that Chairman Moss and Representative Keith undertook the leadership in this area and that aroused interest in the other body, as well as generally, in the subject matter.

It is perhaps fortuitous that the other body has acted first but I think that what they were doing largely is following the leadership of this committee. I want to emphasize that.

The other point that I wish to emphasize is that we had proposed a rather modest appropriation, expecting that it would carry us through the approximately 18 months which we estimate will be necessary for the study.

Here again, I should like to say that, in developing our thoughts about the study, we consulted with and had the benefit of many good suggestions and advice from the staff of the Federal Reserve Board.

Now, I should go further to say, however, that our suggestions are our own. If we have in any way not fully carried out the thoughts that have been brought to us, it is our responsibility, not that of the Federal Reserve Board's staff. But I consider it important to indicate that we did call upon them; they have had a long experience in studying various aspects of the capital markets and they were good enough to give us the benefit of their comments and their time.

The appropriation figure suggested was arrived at after discussion with the General Accounting Office. This discussion was the result of a suggestion of the chairman of this committee. I must say that it was something we had not thought of on our own but it was a most helpful suggestion.

We have, however, not gone through the formal procedures of obtaining Budget Bureau approval. I do not have any reason to believe that we won't get it. I merely indicate that we have not.

I wish also to indicate that in connection with the hearings that we had before the Appropriations Committee I referred to the resolution before you and, as I assess the response, it was most sympathetic.

I have also heard, in the past year and a half, from many Members of the Congress in both bodies, of their great continuing and, in some cases, urgent interest in the completion of a study of this kind.

The $875,000 figure was based on the view that, because of the interest expressed in this matter by groups representing various institutions, they might be able to assist us in certain areas. If that is possible, we will try to live within the $875,000.

If, however, it turns out as we move along, and we are going to have the benefit of advice from the groups representing all these interests, that that sum is inadequate, I may have to come back and ask for additional help.

The reason for saying all of this is that I hope, in the report the committee issues, there may be some reference to the amount involved and the tight time schedule under which we hope to operate, with the hope that this committee will share with us the urgency involved in providing us with the necessary tools.

Now, I should say something further. I have not engaged in any recruiting of any kind except to explore with some of the institutions involved the possibility of eliciting from them names of people who might be considered for this study. I felt it would be presumptuous to do anything more. I hope that this committee can act fairly promptly so that I can get about the business of finding a suitable staff.

I am not sure that I need to say any more except to echo the comments I heard here this morning. The problems in some areas are becoming more acute. However, there is one thing I think I should speak to. I don't recall whether it is in my statement or not.

The resolution as reported out in the other body, and as passed and noted in the report suggested strongly that in connection with this study we look into the question of the concentration of money and power.

We had also contemplated that as a byproduct of this study, we would look into this matter. I want to emphasize that. The Senate committee report, I think, makes a special point of it.

I want to indicate what our views are as to certain differences in the Senate resolution. We would have no objection if this committee determined to amend its resolution to conform to the Senate version. I know that is a little presumptuous on my part. The only reason I undertake to suggest it is because I feel it is urgent that we get on with the study. If that will help, and it does not interfere with any of the views of the committee, I would like to recommend that here today.

Beyond that, Mr. Chairman, I don't know that there is much that I need to speak to.

We have appended to my statement a number of charts and tables which will graphically illustrate the need for such a study and the dramatic and tremendous growth in recent years and the potential resulting from that growth.

Mr. Moss. Mr. Chairman, first, in commenting upon your remarks as to the cost of such a study undertaken by the Securities and Exchange Commission as a result of the initiative of the then Chairman Peter Mack, it was both extent and time and increased appropriations, as I recall.

Mr. Cohen. It was in that connection that I made those remarks because, frankly, we were a little embarrassed then to come back to the committee. Continuing developments, as you and Mr. Keith mentioned this morning, sometimes make that necessary.

Mr. Moss. I think the committee will take full cognizance of the fact that that is certainly an inherent problem connected with any study of the type contemplated here. I use the term "study" advisedly because I think we all recognize that it is a study per se.

Mr. Cohen. I want to emphasize that. It is a study per se. We have no preconceived notions and we should have assistance from all institutions with whom we plan to cooperate throughout the study.

Mr. Moss. I further observe that I think the other item you referred to must be in the——

Mr. Cohen. I think it is.

Mr. Moss. As I recall the amendment they added was the advisory——

Mr. Cohen. Right. I am glad you mentioned that, Mr. Chairman. I forgot about that. I think what they put into their resolution was really probably a statement of what we had indicated we would in any event do as reflected in my correspondence with Mr. Hack who was acting in this connection on behalf of a number of interested securities groups so that the addition of that language——

Mr. Moss. The Commission has no feeling in opposition?

Mr. Cohen. No, sir; we have none at all because it is consistent entirely with the method under which we intend to operate.

Mr. Moss. Mr. Keith.

Mr. Keith. Thank you, Mr. Chairman.

Mr. Cohen. I should say I formally offer my statement for the record.

Mr. Moss. Thank you. It will be received for the record in its entirety. Hearing no objection, it is so ordered.

(Mr. Cohen's prepared statement on H.J. Res. 946 follows:)

Statement of Manuel F. Cohen, Chairman, Securities and Exchange Commission, on House Joint Resolution 946

It is a pleasure to return to this Subcommittee this morning to testify in support of House Joint Resolution 946. As you know, the study of institutional investing that would be authorized by this resolution was first proposed on this side of the Congress by Chairman Moss and Representative Keith, who were among the first to see the need for such a study. The subsequently introduced Senate version of the resolution was passed by the Senate this week, and we are hopeful that we may be allowed to commence work on this important study just as soon as circumstances will permit.

House Joint Resolution 946 will make it possible for us to respond to an important and increasingly recognized need. This need is for more information and understanding about the participation by institutitons in the securities markets, and particularly the stock markets. By "institutions" I refer to such financial intermediaries as banks, insurance companies, mutual funds, pension and welfare funds, foundations and college endowment funds.

The most striking fact about institutional participation in the stock markets is its tremendous growth in comparatively recent years. Institutions have, of course, been significant holders of securities for a considerable period, but prior to World War II most types of institutions, such as insurance companies and pension funds, invested primarily in debt securities, particularly bonds. Mutual funds have invested in stocks ever since their inception, but prior to World War II they were insignificant in size, their total assets amounting to only $450 million, as compared with $46.3 billion at the present time.

I have a few statistics regularly compiled by our staff that will provide an illustration of this growth. These statistics are admittedly incomplete, since adequate statistics simply are not available for certain types of institutions. That fact, incidentally, is a further illustration of the need for the proposed study.

As you can see from Table 1, the total value of the stockholdings of a selected group of institutions rose during the last decade from $29½ billion to more than $131½ billion. The share of total stock outstanding held by these institutions rose during this period from 10.3 per cent to 18.6 per cent. Now I want to point out that these figures cover only those institutions for which we are able to obtain statistics on a regular basis. They do not cover personal trust funds, common trust funds, foundations or college endowment funds. Useful statistics are not available on even a yearly basis for these institutions, and this is one of the information gaps that we hope will be filled by the proposed study. We estimate that at the end of 1967 these other institutions held almost $100 billion worth of stock, or 14.2 per cent of the total stock outstanding at that time. In other words, the total institutional stockholdings amounted to an estimated $230 billion, or about one third of total stock outstanding at the end of 1967. This compares with $65 billion, or 23 per cent of outstanding stock a decade ago.

The statistics that we do have are sufficient to portray the sharp growth not only of institutional shareholdings but also of the participation of institutions in he stock markets. Turnover rates of what are perhaps the two most important institutional groups, investment companies and pension funds, are much higher than they were just ten years ago. As shown in Table 2, investment companies turned over, on the average, almost 39 per cent of their stock portfolios in 1967, compared with a 14 per cent rate a decade ago. The average turnover rate of private noninsured pension funds rose from less than 4 per cent in 1957 to over 11 per cent last year. Individual institutions differ considerably in the rates at which they turn over their portfolios. Data available to the Commission on investment companies show that some funds turn over their portfolios at annual rates approaching and even exceeding 100 per cent. Table 3 shows the breakdown of portfolio turnover rates for mutual funds in 1967. I am not suggesting that there is anything improper about this increase in turnover rates, or that we have concluded that any particular turnover rate is desirable or undesirable for the institutions involved or for the markets. The proposed study, however, will enable us to determine both the reasons for this phenomenon and its effects.

It would seem readily apparent that growth of this magnitude must necessarily have an important impact not only upon the functioning of securities markets but also upon the raising of capital by American business, the interests of individual investors, who also use the securities markets, and the companies in whose stock these institutions invest. It is also a significant economic phenomenon, and analysis and study of this phenomenon by competent economists, which is an important part of the proposed study, should contribute materially towards our understanding of the workings of the economy.

Concern with the role of institutional investors in the stock market is, of course, not new, nor has it been confined to the Commission. As long ago as 1955, the Senate Committee on Banking and Currency instructed its staff to coordinate a study of the participation by institutional investors in the stock market. On the basis of data collected for the 1953 to 1955 period the study concluded that institutions had a significant impact on stock prices generally and on the prices of specific stocks in particular, but that institutional trading primarily reflected shifts in the evaluation of business prospects. A few years later, in the early 1960's, the SEC's Special Study of Securities Markets devoted a portion of its efforts to institutional trading and raised many more specific questions about the manner in which institutions trade and their importance to the various markets and to various participants in those markets.

Although these studies shed considerable light on institutional activity, they had limited objectives and limited resources. The 1955 study by the staff of the Senate committee was a pioneering effort to obtain some data on the amount of institutional activity in particular stocks, and our Special Study of Securities Markets was primarily devoted to other objectives. The same can be said of the Commission's report on the Public Policy Implications of Investment Company Growth, filed with the Congress in 1966. That study was directed to investment companies (primarily mutual funds) and devoted some attention to the impact of mutual-fund growth upon the securities markets and upon portfolio companies. We noted, however, that this impact could not be considered in isolation from that of our institutional investors, and that, although considerable data about the activities of mutual funds were available as a result of the disclosure and reporting requirements of the Securities Act and the Investment Company Act, there are very few data available about the activities of many other kinds of institutional investors. We consequently concluded that acquisition of such data was "an indispensable preliminary step to adequate analysis of the problems raised by the institutionalization of the securities markets."

The available data with respect to the activities of various types of institutions in the stock markets range from fairly extensive information about registered investment companies, collected not only by the Commission but also by the Investment Company Institute, to almost no information at all about foundations, of which there are roughly 15,000 with about $19 billion in assets and $14 billion in stock at the end of 1965. No reports are required of foundations, except to the Internal Revenue Service, and stock data on even a total-dollar-value basis are generally unavailable. In between these extremes there are bank-administered pension funds, bank trust funds and insurance companies. With respect to pension funds and property and casualty insurance companies our staff collects a certain amount of statistical data on a voluntary basis, and with respect to life insurance companies the Institute of Life Insurance collects certain monthly data from companies accounting for 93 per cent of total assets. As to none of these, however, do we have data on individual transactions or holdings in individual stocks. For insurance companies this information exists in the reports that they file with state regulatory authorities having jurisdiction over them, but these data have not been assembled or published in the past.

Obviously, the first task of the proposed study would be to remedy these various information gaps. Only after this is done can there be any meaningful analysis of the impact of institutional investment upon the securities markets and upon the economy. This will involve not merely the gathering of statistics but also a detailed examination of trading practices and their purposes and effects. As I have mentioned elsewhere, I think a mere one-shot collection will not be sufficient. We must create a mechanism to provide a flow of needed information on a continuing basis. I hope that the proposed study would, as a byproduct, produce a determination as to how this can best be done and what types of data are particularly needed.

The proposed study would not be completed with the general gathering and compilation of the necessary data. I visualize the proposed study as focusing primary attention in three or four areas that are both complex and important. These would include the impact of institutional investment upon the stock markets, upon the securities industry and upon the investing public; the economic aspects of institutional investment, including its effect on sources and allocation of capital, the amount and nature of savings and the level of stock prices; the impact of institutional investment upon the companies in whose stock institutions invest and the proper role of a financial institution as a stockholder; and, finally, probable future developments with respect to the growth and nature of institutional investment and the purposes, motives and objectives of the institutions themselves.

I shall turn first to the institutional impact on the stock market. One aspect of the matter is reasonably clear: Institutionalization has thrown a very considerable strain on the existing organization of the stock markets.

The stock exchanges as we know them were designed as central auction markets to which there would flow a multitude of orders, each relatively small, from a multitude of individual investors, with prices for individual stocks being determined from moment to moment by the forces of supply and demand. The specialist was to intervene to the extent necessary to preserve continuity and provide liquidity. Since individual investors buy and sell on the basis of a great variety of information and for a great variety of reasons, the expectation, based on past experience, was that, under normal circumstances there would be a reasonable balance of buy and sell orders, and any temporary imbalance could be handled without too much difficulty by the specialist.

When this mechanism for the central auction market was designed, little consideration was given to the different market behavior and impact of institutional investors, which were not then so significant a factor as they have become today. Since institutions tend to buy or sell in fairly large qantities, the number of large block transactions has been increasing by leaps and bounds. For example, transactions in blocks of over 10,000 shares on the New York Stock Exchange have quintupled since 1964, rising from 399 in the fourth quarter of that year (the earliest period for which we have any data) to 1991 in the first quarter of this year. Furthermore, institutional investing does not exert pressures on the stock market merely because of the size of the transactions. Institutions are managed by professional money managers. These men have access to much the same information, and many of them are trained to analyze it in much the same way. The consequence is that, when one institutional manager decides to sell, it is quite possible that other institutional managers will reach the same decision at about the same time, further intensifying the likelihood of imbalance in the markets.

All this can have serious consequences. Stock markets do not satisfactorily perform their basic economic function if prices bounce erratically up and down, either generally or with respect to individual securities, for reasons unrelated to any changes in the affairs of the companies, and individual investors who get caught in such a tide can get hurt. We shall, accordingly, have to study the ways and means by which the exchange and, for that matter, the over-the-counter markets can better adjust themselves and their mechanisms to the impact of a pattern of institutional trading that appears to differ very significantly from the historic patern of trading by individual investors.

I shall not endeavor to get into the economics of institutional investment at this time, particiularly since I am not an economist. I should like to say, however, that in my opinion a great deal more attention to the institutions, mechanisms and practices in the securities markets could be paid by professional economists of high caliber than has heretofore been the situation. One reason for this absence of attention has been the lack of adequate data with which to work, and the proposed study would also provide an important impetus in that direction.

The relationship of institutional investors to the companies in which they invest has become increasingly important. At the end of 1967, 272 (or 21.4 per cent) of the 1274 corporations whose shares are listed on the New York Stock Exchange—including such corporate giants as Anaconda, Penn-Central and Westinghouse Electric—had 10 per cent or more of their common stock owned by one or more mutual funds or closed-end investment companies. The appropriate conduct of investment companies that find themselves in such a situation is a controversial subject. According to one school of thought, institutional investors should not concern themselves with the management policies of portfolio companies, except to sell if they do not like the policies of a particular company. According to another school of thought, institutional investors, with their knowledgeable professional managers and the influence that they can exert by reason of the size of their holdings, can serve as spokesmen for stockholders generally and protectors of their interests. Members of this school point out that such active participation in the affairs of portfolio companies may be necessary for the institution to protect its investment, since it is not always easy for an institution to dispose of a large block of stock.

Institutional participation in the affairs of its portfolio companies may go beyond that of influencing the policies of present managements. A further question brought into focus by recent developments is whether it is proper or economically or socially desirable for institutional investors holding large blocks of securities to participate in efforts to take over a company or dislodge its management. To some this may appear as an effective means of getting rid of a management claimed to be ineffective, while to others it could be viewed as providing an opportunity for exercise of economic power in ways that may be detrimental to American industry and other investors. Institutional investors, it appears, are themselves unsure and divided as to what role they can or should play as stockholders. The proposed study will provide a means to explore what institutions actually do in this area, why they do it and what the effect is upon corporations and their managements.

Finally, we know that institutional investment is growing very rapidly. But we do not know enough about why it is growing, whether it will continue to grow and, if so, at what pace, what the consequences of this further growth may be and what measures will be necessary to cope with them.

I should like to emphasize two things about this study, particularly since some apprehension was expressed about them at one time. In the first place, we intend this to be a dispassionate study that will examine basic economic phenomena. Our purpose is to marshal the facts and other relevant considerations and to arrive at reasoned judgments. We are not looking for malefactors or seeking enforcement cases or trying to prove some point. In the second place, as I pointed out in a letter dated February 14 to Mr. Robert W. Haack, president of the New York Stock Exchange, we intend to work extremely closely with all interested persons, including institutional investors, members of the securities industry and representatives of other government agencies. We shall establish an advisory committee that would participate at all phases, including the development of final conclusions. The Senate version of the joint resolution specifically provides that the Commission shall consult with all interested persons and establish and consult with an advisory committee. We understand that this was included to reflect our intentions and to eliminate any question as to our authority to do so. Consequently, we would have no objection to the addition of similar language to the resolution on this side.

House Joint Resolution 946 leaves blank the amount of money authorized to be appropriated for the proposed study. We have attempted to determine the smallest appropriation with which it would be feasible to carry out as extensive a study as this resolution envisages. In my letter of January 17, 1968, I furnished your subcommittee with an estimated budget of $875,000, which had been reviewed by the General Accounting Office in accordance with your request. While $875,000 appears to be a reasonable sum of money for the proposed study, we will, of course, have to prepare and submit a budget request for that amount to the Bureau of the Budget for review and approval.

House Joint Resolution 946 directs the Commission to report the results of its study and its recommendations to the Congress on or before January 20, 1969. More than six months, however, have passed since this resolution was first introduced. The Senate version has a deadline of December 31, 1969. We would prefer to have the resolution specify a definite study duration rather than a specific reporting deadline. A period of 18 months from the time funds are available and the study is initiated to the submission of the final report would seem to be about as tight a time schedule as we would wish to commit ourselves to.

In closing I shall repeat that this resolution proposes an economic study that is very important and, in my view, necessary to the continued healthy functioning of our securities markets and to the full understanding of our national economy. We have been assured of the cooperation of the securities industry and of most groups of institutional investors who have expressed any view. We hope, therefore, that this study can get under way as soon as possible, and we warmly support House Joint Resolution 946.

TABLE 1.—STOCKHOLDINGS OF FINANCIAL INSTITUTIONS AND OTHERS

[In billions of dollars] [1]

	End of year				
	1957	1964	1965	1966	1967
1. Private noninsured pension funds	7.5	33.5	39.7	38.5	51.3
2. Investment companies, total	12.2	34.6	41.2	37.4	51.0
(a) Open end	7.7	26.7	33.5	31.2	42.8
(b) Other	4.5	8.0	7.7	6.2	8.2
3. Life insurance companies	3.4	7.9	9.1	8.8	10.7
4. Property and casualty insurance companies	5.2	11.4	12.0	11.0	13.3
5. Banks	.9	1.6	1.8	1.7	1.9
6. State and local trust funds	.3	1.7	2.4	2.8	4.2
7. Fraternal organizations	.1	.2	.2	.2	.2
8. Total institutions (1 through 7)	29.5	90.3	105.7	99.6	131.6
9. Foreigners [2]	9.5	18.9	19.9	18.1	22.5
10. All others [3] (item 11 less items 8 and 9)	246.2	510.0	549.1	469.7	553.5
11. Total stock outstanding	285.2	619.2	674.6	587.4	707.6

[1] Estimated market values of peferred and common stock. Excludes investment company shares but includes foreign issues outstanding in the United States.

[1] Figures may not add to totals because of rounding

[2] Includes estimate of stock held as direct investment.

[3] Includes individuals, personal trust funds, and nonprofit institutions.

MARKET VALUE OF COMMON STOCK
HELD BY SELECTED FINANCIAL INSTITUTIONS

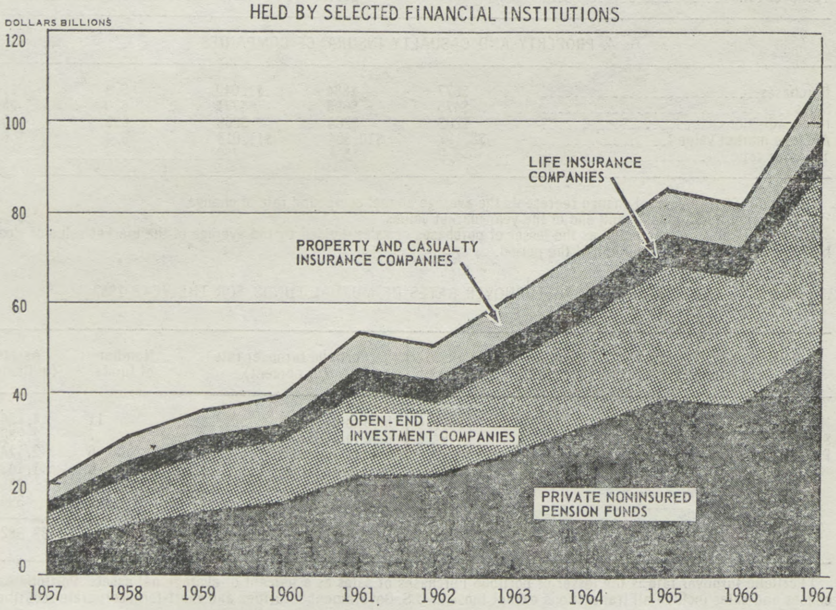


TABLE 2.—COMMON STOCK TRANSACTIONS

[Dollar amounts in millions]

	1957	1966	1967	Average annual percent change[1] 1957–66	Average annual percent change[1] 1966–67
1. PRIVATE NONINSURED PENSION FUNDS					
Purchases	$1,340	$6,631	$10,058	19.4	51.7
Sales	$252	$3,005	$5,058	31.7	68.3
Net acquisitions	$1,088	$3,626	$5,000	14.3	37.9
Average market value[2]	$6,638	$38,339	$44,128	21.5	15.1
Turnover ratio[3]	3.8	7.8	11.5		
2. OPEN-END INVESTMENT COMPANIES					
Purchases	$1,696	$10,343	$14,926	22.2	44.3
Sales	$993	$9,309	$13,325	28.2	43.1
Net acquisitions	$703	$1,034	$1,601	4.4	54.8
Average market value[2]	$7,145	$29,353	$33,430	17.0	13.9
Turnover ratio[3]	13.9	30.8	38.7		
3. LIFE INSURANCE COMPANIES					
Purchases	$247	$1,012	$1,716	18.1	55.7
Sales	$203	$825	$890	16.9	7.9
Net acquisitions	$44	$277	$826	22.7	198.2
Average market value[2]	$1,891	$6,034	$6,951	13.8	15.2
Turnover ratio[3]	10.7	13.7	12.8		
4. PROPERTY AND CASUALTY INSURANCE COMPANIES					
Purchases	$677	$884	$1,040	6.9	17.6
Sales	$475	$600	$771	6.0	28.5
Net acquisitions	$202	$284	$269	8.9	−5.3
Average market value[2]	$8,102	$10,354	$11,018	6.4	6.4
Turnover ratio[3]	5.9	5.8	7.0		

[1] For 1957–66, the percent change represents the average annual compound rate of change.

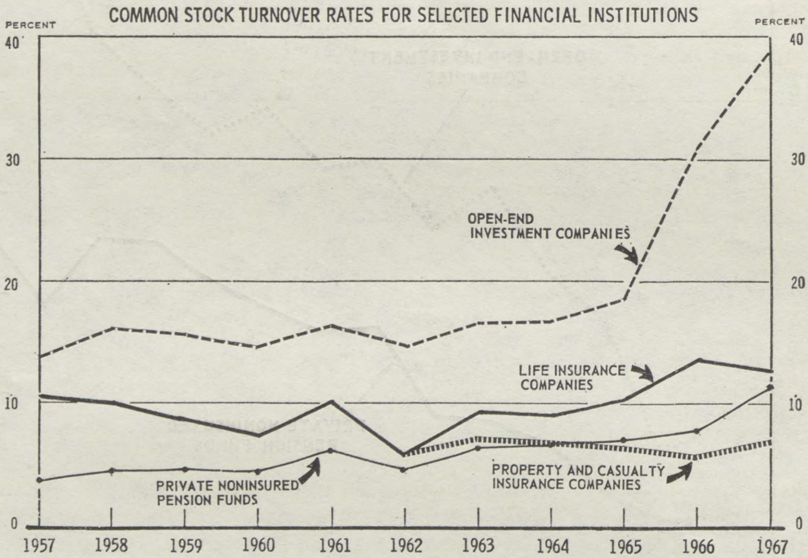
[2] Average of the beginning and end of the year market values.

[3] Turnover rates are computed as the lesser of purchases or sales divided by the average of the market value of stockholdings at the beginning and end of the period.

TABLE 3.—PORTFOLIO TURNOVER RATES OF MUTUAL FUNDS FOR THE YEAR 1967

Portfolio turnover rate[1] (in percent)	Number of funds	Assets (millions)	Portfolio turnover rate[1] (in percent)	Number of funds	Assets (millions)
No Transactions	20	$602.6	50.0 to under 60	11	4,124.7
Sales only	2	94.2	60.0 to under 70	7	2,280.3
Purchases only			70.0 to under 80	6	2,124.8
0.1 to under 10	27	2,637.7	80.0 to under 90	8	1,143.7
10.0 to under 20	21	11,660.3	90.0 to under 100	2	655.3
20.0 to under 30	20	10,128.1	100.0 and over	10	396.3
30.0 to under 40	18	2,454.4			
40.0 to under 50	8	1,580.4	Total	160	39,882.9

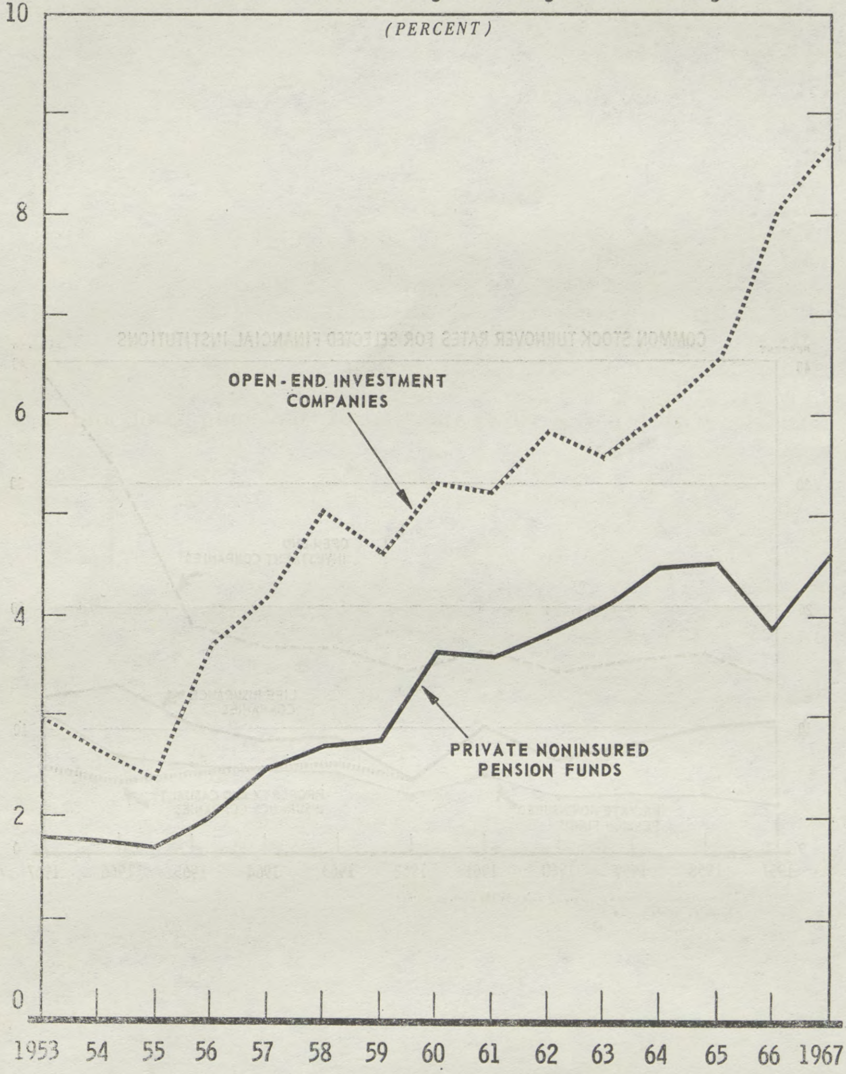
[1] Portfolio turnover rate is the lesser of portfolio purchases or sales as a percent of average net assets. Portfolio purchases and sales include all transactions except those in U.S. Government securities and short-term corporate securities.



NOTE: Turnover rate computed by dividing sales by the average market holdings for the period

COMMON STOCK TRANSACTIONS OF OPEN-END INVESTMENT COMPANIES AND PRIVATE NONINSURED PENSION FUNDS

As a Percent of Stock Trading on all Registered Exchanges



Mr. Keith. I find myself a little pressed to comment on your observations that you have no preconceived notions. The speculation that prompted this study is so extensive and so serious in its consequences and so really meaningful to the small investor who gets sucked into a movement in a market which he can't comprehend and buys at the wrong time and sells at the wrong time, for the wrong reasons, that the public has a great deal at stake.

We don't know enough about this problem so that a study is necessary. We don't know enough about this problem to have some ideas of what we really can do about it.

I would hope that as you study this, if you uncover some phenomena on which light should be shed that you would not hesitate to do so, either through the vehicle of asking for a hearing on the subject or speeches to the industry, to the public, that would let them know the direction in which you were moving and the conclusions that you are reaching. It would help the situation if they could be brought to public view.

Mr. Moss. Will the gentleman yield?

Mr. Keith. Yes.

Mr. Moss. I would like to say that it will be my intention that this subcommittee exercise, as is contemplated in the Reorganization Act, full oversight to keep ourselves fully informed of the problems.

Mr. Cohen. I am reminded of the rule I should adhere to but very seldom do—when you are ahead don't argue with the judge—and I am ahead. I appreciate this colloquy very much, because it is entirely consistent with my own views and that of the Commission and, I believe, all of industry.

There is one thing I am never accused of and that is being bashful about making recommendations. I can assure you that as soon as we are prepared so to do, we will be up here. But I do want to indicate that for the past year and a half I have spoken out on this subject to the industry.

I should also add that the industry leaders have themselves spoken out on this subject. They are concerned. They have undertaken a number of measures. Only this week you may have noticed certain advertisements put out by some of the larger firms. What happened this week is merely a reflection of what has been happening in recent weeks.

There is a growing concern within the industry itself that this speculative activity may be reaching a point of some risk and danger to all. I do want to emphasize that our study here is not concerned solely with matters of speculation. Whether that is a descriptive term or pejorative term, there will, I suppose, always be a certain amount of speculation in a free market. I am not sure that a certain amount of it is necessarily harmful.

Our study would deal with that but is designed to deal with some broader questions as well.

I think some reference was made this morning by the chairman to this development, this dramatic development, and its effect on the securities markets and stock exchanges; in particular, in recent years, the ability of the markets to cope with these developments. They have instituted a number of procedures designed to deal with certain of them. We would also study the relationship between the management of large aggregates of funds and the managements of the portfolio companies, any differences in approach among institutional investors, and the provision of information in some areas where no one really has good information.

Our study is intended to be a broad one. As I indicated a few minutes ago, the Senate committee introduced the suggestion that we should not overlook the problems inherent in the growing concentration of large sums of money. We have always felt that this would be an aspect of our study. I restate it here to indicate no difference with the views of the Senate committee in this regard.

Mr. KEITH. Going for a moment to H.R. 7696 which would extend the regulation to over-the-counter securities, is this not intended to dampen the ability to speculate?

Mr. COHEN. I would prefer that you put that question to Governor Robertson. It is their bill. I would answer your question, however, Mr. Keith, that it will provide additional tools for the Federal Reserve Board, which traditionally has been concerned with this problem, to deal with it if the Board determines that is appropriate and in a way which, conceivably, may dampen at least the excessive use of credit in the market which frequently accompanies the speculative excesses.

Mr. KEITH. I have no further questions.

Mr. MOSS. Mr. Stuckey, do you have any questions at the moment?

Mr. STUCKEY. Good morning, Mr. Chairman.

Mr. COHEN. It is good to see you again, Mr. Stuckey.

Mr. STUCKEY. This study will be conducted in cooperation with the presidents of both of the exchanges; Is that right?

Mr. COHEN. It will, we hope, be conducted with the fullest cooperation, to the extent that they will advance it, not only from the securities industry but also from representatives of the various types of institutions concerned, the banks, insurance companies and, to the extent that we find representative groups, the pension fund people, and institutions such as hospitals, colleges, and foundations.

We hope to elicit not only their cooperation and their advice but indeed, to the extent that it is appropriate and available, their assistance to do this on a comprehensive and continuing basis.

Mr. STUCKEY. Mr. Chairman, I haven't had an opportunity to go into depth on this but I notice there is a lot of concern about the amount of turnover in a portfolio. This has given some concern.

Will the study go ahead definitely into new issues, the turnover on new issues?

Mr. COHEN. The study will.

However, I want to introduce a word of caution. First, I should say that while the resolution deals with the effect of the growth of institutions on the securities markets, securities markets include a great many types of securities. At the moment at least, subject to further study of this problem with the various industry groups involved, it is our thought that we will probably concentrate on the equity market. This obviously will raise the question that you just put.

There is a difference in approach among the different institutions although that approach is being narrowed all the time. The greater turnover in the mutual fund area is continuing but some of the others, who have traditionally been less turnover-minded, if I can use that expression, are becoming much more active each year.

Mr. STUCKEY. Let me ask you some questions and see if these are areas of concern that you will go into because some of them do give me a great deal of concern.

One is the way the market is quoted on the mutual funds, twice a day; the price is set twice a day. Does this give you concern? Is it something worth going into?

Mr. COHEN. It so happens that this is a matter which, at the moment, is the subject of rulemaking before the Commission. The two-price system is something that came into effect after the passage of the 1940 act, although there were perhaps a few funds that voluntarily had undertaken that system before.

Actually, the majority of the funds had not had such a system. In fact, some of them did not even have a one-price-a-day system. Now, we are engaged in considering a proposed rule dealing with an aspect of the pricing system, the backward pricing system as against the forward pricing system.

Based on the information made available to the Commission, we have been concerned about the use of the backward pricing system and the potential that it has for dilution of existing shareholders and also the potential it has to stimulate a certain amount of speculation. We are concerned about that right now, and working on it wholly apart from the study.

Obviously, in the study we will be looking at all aspects of institutional behavior as it is related to the securities markets, and we will probably pursue this a little further.

Mr. STUCKEY. Are you going into the specialist system to some extent?

Mr. COHEN. We will. I think we must. I think one of the concerns expressed this morning by the chairman and one we share and I think the industry shares is the ability of the specialist to deal with this growing concentration. I think it is fair to say we will look into that.

Mr. STUCKEY. Mr. Chairman, I do not want to take up too much time but I want to commend you on the study that you are about to undertake.

Mr. COHEN. Thank you, sir.

Mr. MOSS. Are there further questions?

If not, Mr. Chairman, we want to thank you for your appearance.

Mr. COHEN. Thank you, Mr. Chairman.

(The following additional information was subsequently submitted:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., July 9, 1968.

Hon. JOHN E. MOSS,
Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. MOSS: In connection with the consideration of H.R. 7696 and S. 1299, I am pleased to enclose statements of the Commission concerning the application of margin regulation to market-makers in over-the-counter securities and to the sale of mutual fund shares.

Sincerely,

MANUEL F. COHEN, *Chairman.*

MARKET MAKERS

In the over-the-counter market substantial markets are made by "integrated" firms performing both the market making and retail function. If such a firm is a dominant market maker in a particular security and is permitted to extend margin credit to its customers on that security, it could, by virtue of its control over prices and quotations, trigger margin calls in order to obtain funds for the operation of its business, to cover short positions, or to increase long positions, and could otherwise act in a manner which would create significant regulatory problems. This conflict of interest and the consequent potential problems would be alleviated if the criteria for determining which securities are eligible for margin included a requirement of independent competitive market makers, which would make it less likely that any one dealer could have a dominant influence on price movements. Further study will be required to develop appropriate rules in this area.

SECTION 11(D)(1)—MUTUAL FUND SHARES

Section 11(d)(1) prohibits a broker-dealer from extending credit on any security (other than an exempted security) which is part of a new issue in the distribution of which he participated as a member of the selling syndicate or group within 30 days prior to the transaction. A broker-dealer distributing mutual fund shares, whether as a principal underwriter or retailer, is deemed to be a member of the selling syndicate or group, and the mutual fund shares being sold in connection with their original distribution are deemed to be a "new issue" subject to the credit restrictions.

While the procedures followed in the distribution of mutual fund shares are not exactly the same as those followed in the more traditional distributions, and even though they may be in what is referred to as "continual registration", the sales load on mutual fund shares is substantially more than the commission or markup in an ordinary purchase or sale which is not part of a distribution. One of the important functions of the credit restrictions of Section 11(d)(1) is to prevent or discourage a broker-dealer who has a financial interest by way of underwriting spread or selling group member's allowance or reallowance (which are generally significantly higher compensation than the ordinary commission or markup in secondary transactions) from "sweetening" the transaction by offering to extend credit to the customer. This would appear to be as undesirable in the distribution of mutual fund shares as in the distribution of other new issues.

While we do not at this time think that it would be appropriate to permit mutual fund shares to be sold on credit in connection with their original distribution, if, at a later time, it should be determined that it would be appropriate to permit the extension of credit in connection with their distribution, this could be accomplished under existing statutory provisions; no amendment of Section 11(d)(1) would be necessary to accomplish this. The Commission has the power under Section 3(a)(12), if it should deem it necessary in the public interest, to exempt mutual fund shares from the prohibitions of Section 11(d)(1), if, after enactment of the present legislation and subsequent adoption of Federal Reserve Board regulations, it should be determined that mutual fund shares were a proper subject for sale on margin.

Mr. MOSS. Our next witness will be Vice Chairman of the Board of Governors of the Federal Reserve System, Mr. J. L. Robertson.

We welcome you here today.

You may, if you wish, summarize your statement for the benefit of the committee, or you may read it verbatim.

STATEMENT OF HON. J. L. ROBERTSON, VICE CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. ROBERTSON. Thank you, Mr. Chairman.

I do appreciate the opportunity to present the views of the Board on both H.R. 7696 and House Joint Resolution 946.

I think in view of the statement which you made at the outset, the best thing I can do for this committee is simply to say we strongly endorse the remarks which you made and support both of these bills, and I would be very glad to merely submit my statement for the record, if you wish, because it is not in discord at all with the comments which you made but I will do anything you would like to have me do.

I think the legislation is so obviously needed and deals with the subject of such concern that there can't be much dispute about it.

Mr. MOSS. That is my reaction. That is why I have no questions. I have followed the matter closely in the other body.

Mr. Keith, you are recognized for any questions you may have of Mr. Robertson.

Mr. KEITH. I am sorry that I have not had time to read your prepared statement. I know how you feel about the matter.

Because of your easy access, if I have any further questions I will submit them to you.

Mr. ROBERTSON. We will be delighted to respond at any time.

Mr. MOSS. In view of the absence of questions, your statement is received and will be included in the record at this point.

(Mr. Robertson's prepared statement follows:)

STATEMENT OF J. L. ROBERTSON, VICE CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, ON H.R. 7696 AND HOUSE JOINT RESOLUTION 946

I appreciate the opportunity to present the views of the Board of Governors on H.R. 7696, which would extend margin requirements to actively-traded over-the-counter stocks, and H.J. Res. 946, which would authorize a study of the activities of institutional investors by the Securities and Exchange Commission. As indicated in a recent letter to Chairman Staggers, the Board believes that there is evidence of substantial speculative activity, partly credit-financed, in over-the-counter securities, underlining the need for prompt action on H.R. 7696, and we welcome your prompt response in scheduling this hearing.

H.R. 7696 was introduced by Chairman Staggers at the Board's request. It would amend section 7 of the Securities Exchange Act of 1934 so as to extend margin requirements to over-the-counter securities. Section 7 now authorizes the Federal Reserve Board to limit the credit that brokers and dealers may extend on securities that are registered on a national securities exchange and to limit the credit that banks (and other lenders) may extend for the purpose of purchasing or carrying equity securities that are so registered. However, with respect to securities that are not traded on exchanges but only "over the counter" ("OTC"), that Act forbids brokers and dealers, generally speaking, to extend any credit whatever, and permits banks to extend credit without being subject to any Federally-imposed margin requirements.

Under the authority granted by the bill, the Board would issue regulations extending margin requirements to those OTC securities which are actively traded in markets sufficiently developed to make such regulation feasible and appropriate. For these actively-traded OTC securities, the effect would be to enable brokers and dealers to extend credit subject to the margin requirements (whereas now they are prohibited from extending credit at all) and to limit the amount of credit that banks may extend (because the margin requirements would at the same time be applied to loans by banks).

As you know, in March of this year the Board amended its margin regulations to broaden their coverage and to close some loopholes that appeared to have developed. The amendments extended margin regulations to lenders not previously covered, brought credit on certain convertible bonds under margin regulation for the first time, required an orderly bring-up over time of special low-margin subscription accounts to regular margin status, and restructured the regulations in an effort to minimize evasions. And earlier this month the Board raised margin requirements from 70 to 80 per cent.

None of these changes, however, had any impact so far as over-the-counter securities are concerned. Under the law as it now stands, the Board's authority is restricted to credit used to purchase or carry exchange-registered securities. We believe that safeguards against the excessive use of credit in the over-the-counter securities market are still badly needed to round out the protection afforded the public by margin regulation in the volatile securities area. At the same time, we can see no reason why brokers and dealers should not be permitted to extend credit to customers at regulated margins, at least on the more active and widely traded over-the-counter stocks. Therefore, in order to make margin requirements both more effective and more equitable, the Board strongly supports H.R. 7696.

Let me briefly outline the background and the need for this legislation, before I discuss the Board's plans for implementing the bill, as well as its long-range objectives under the authority that would be granted.

BACKGROUND

Before passing section 7 of the Securities Exchange Act of 1934, the law which H.R. 7696 would amend, Congress determined that the financial crisis of the preceding period had been caused in part by excessive credit flowing away from commerce and industry into the stock market, largely in the form of brokers' credits used to purchase or carry stocks registered on national securities exchanges. Congress, however, also recognized that if brokers' credits alone were restricted, credits from other sources—particularly banks—would likely assume the role of the major source of stock market credit.

The 1934 Act accordingly authorized the Board to regulate both (1) credit that brokers may extend on securities registered on an exchange, and (2) credit that banks and other lenders may extend for the purpose of purchasing or carrying securities registered on an exchange. But the Act controls brokers' credits much more strictly than credit by banks and others by prohibiting brokers from extending credit on securities traded over the counter, while banks and others may lend on such securities without restriction, unless the purpose is to purchase registered stocks. The Board commented on this disparity of treatment in its 1964 *Annual Report* to Congress, as follows: "The present arrangement is inequitable in its contrasting treatment of brokers and banks. In addition it limits the effectiveness of salutary controls over security credit and unnecessarily deprives over-the-counter securities of credit facilities that might appropriately be extended by brokers and dealers."

PURPOSES OF AMENDMENT

Adoption of H.R. 7696 will permit the Board to move toward a more nearly equal treatment of all lenders (brokers, banks, and others) with respect to credit extended for the purpose of purchasing or carrying over-the-counter securities. Presently, the principal regulation applying to equity securities listed on the exchanges imposes an initial margin requirement of 80 per cent. This means in effect that anyone buying a $100 stock on credit must put up $80 in cash, or in securities with an equivalent *loan* value. Another way of saying this is that a loan on a $100 stock can not exceed $20. It must be kept in mind, however, that these rules on margin credit for listed stocks apply *only* to loans that are for the purpose of purchasing or carrying such securities. They do not apply when loans collateralized by listed securities are obtained for other purposes, such as to pay taxes, meet emergency expenses, finance a business, buy a house or car, or any other of the many and varied uses for which people borrow money.

In 1934, the difference in treatment for credit purposes between listed and unlisted stocks was not considered important because the over-the-counter market was relatively insignificant. In the intervening years since then, however, trading volume in the OTC market has risen sharply. At the time the Securities Exchange Act of 1934 was adopted, it is estimated that the dollar value of OTC trading was less than one-sixth of that on organized exchanges. By 1961, the ratio had risen to three-fifths, and since then it is believed that OTC transactions have grown even more rapidly relative to volume on the exchanges, though no definite data are available. This trend is likely to be accentuated by the fact that under the 1964 Securities Acts Amendments, firms with 500 or more shareholders and assets of more than $1 million, whose securities are traded over the counter, must disclose information to the public respecting their business and finances in much the same fashion as companies whose securities are registered on exchanges. This new, readily-available information has a natural tendency to attract additional investors into the over-the-counter market and increase its size and importance.

As the volume of total trading in over-the-counter markets has increased, the scale and pattern of activity in some unlisted stocks have come to resemble those of securities traded on the exchanges. With the increased investor interest and expanded trading activity in the over-the-counter market, it appears to us inconsistent to continue the difference in margin regulation status between exchange-traded stocks and the unlisted stocks which most closely resemble them.

It may be noted also that the over-the-counter market itself has taken on some of the characteristics long identified with the organized exchanges due, by and large, to expanded investor interest and technical advances in trading operations. This market development has produced an economic framework that facilitates the use of credit to finance the purchase of unlisted stocks. More reliable quotations of prices, the basis for ascertaining the "current market value" of securities pledged for margin loans, are now available. Further, with increased volume, the market now has a greater "depth"—a necessary prerequisite for *orderly* liquidation of stock collateral in cases of default.

BOARD ACTION IF H.R. 7696 IS ADOPTED

H.R. 7696 would not directly affect the present scheme of securities-market credit controls; it would simply broaden potential coverage by authorizing the Board to encompass OTC securities within its credit regulations. For exchange-traded stocks, present margin regulations would continue to operate as they do now. Under the authority granted by the new legislation, the Board would simply extend these regulations from time to time to those OTC securities for which such regulation is deemed to be appropriate.

It is not the Board's present intention to include all or even most unlisted equities within the regulations. Many over-the-counter securities are not actively traded and, therefore, are frequently subject to less than firm price quotations. Moreover, many OTC stocks do not attract broad investor interest and probably are not suitable for margin regulations. Thinness of markets and lack of a broad investor following imply sufficient potential price volatility so that the use of credit in financing investment in such stocks should not be encouraged. Consequently, we do not contemplate any change in present requirements with respect to this large category of OTC securities.

H.R. 7696 permits the Board to develop specific standards which would determine the securities that should be covered. This would be done by regulation, and industry comments and suggestions would be solicited through advance publication of the proposed rules. The Board's intention would be to develop standards that will encompass within the ambit of margin regulation those OTC stocks which have market and investor characteristics similar to those of exchange-traded stocks.

At present, about 20,000 securities are traded over the counter and daily price quotations on nationally-traded stocks are disseminated to the public for 1200 to 1500 issues. The Board believes, however, that only a few hundred of these are traded in sufficient volume to assure reliable pricing, reasonable liquidity, and substantial investor and dealer interest. The Board's initial task will be to develop indexes of present and prospective market behavior to be applied to individual issues, based on such factors as the number of shares outstanding, number of stockholders, assets and earnings of the issuer, continuity of market price quotations, number of dealers that make markets in the issue, indicated volume of trading, and other factors. As already broadly stated, these measurements would be designed to limit the list of OTC securities to be included under margin requirements to those issues that are the most active, and that would meet most, if not all, of the prerequisites for exchange listing.

We recognize also that there are problems involved in relating credit regulation to the mechanics of the market that must be resolved and that require further study. Markets for over-the-counter securities are made by dealers who perform a necessary role in seeing that those markets are orderly and reliable. To perform this function, the market-maker needs access to credit on a liberal basis. Credit extended to firms that make markets in the OTC securities which are brought within the scope of margin regulation thus would probably have to be exempted from the operation of margin regulation in much the same way that credit to the specialist on the exchange—who is the counterpart of the OTC market-maker—is exempted from margin regulation today.

On the other hand, the securities dealer who makes a market in OTC securities differs from his exchange counterpart in that he is both a wholesaler and a retailer. This fact could produce conflicts or interest, especially when a firm both positions a security and extends credit on it to its retail customers. Such a firm conceivably might be tempted to manipulate market prices of the securities in which it made a market, in order, for example, to force margin calls when it needed funds. Limiting margin treatment to the most active OTC securities would largely obviate this problem because it would generally bring under margin regulation only those OTC securities in which enough different firms make markets so that there is little chance of domination by a single firm.

The Board recognizes that the formulation of standards with regard to this and other market characteristics is a difficult task and has asked for and been assured of the assistance of the Securities and Exchange Commission in the development of such regulations.

The approach of H.R. 7696—that is, the flexibility which would permit the Board to develop specific standards in the light of study and experience—seems highly desirable. This approach allows the Board to adapt the coverage of margin regulations to future developments in the OTC market. It is clear that the OTC market is continuing to develop rapidly. This market is particularly susceptible to automation. Plans are already underway to funnel transactions in the market through central computers, which would tend to create a more reliable market with more accurate price information. At the same time, the trend toward increasing trading activity in a wider and wider list of stocks, in conjunction with automation, may also serve to increase the range of OTC issues attracting the use of credit. These and other developments, however, cannot be foreseen accurately, so that flexibility in the enabling legislation is needed if the Board is to make appropriate regulatory adjustments as markets evolve.

HOUSE JOINT RESOLUTION 946

The Federal Reserve Board also recommends enactment of H.J. Res. 946. This resolution would authorize an SEC study of the investment activities of financial institutions, such as insurance companies, pension funds, mutual funds and bank trust departments. Institutional investors in the United States for many years have provided the major channel through which credit flows from savers to borrowers, and more recently they have become the dominant channel for equity funds as well. By the end of 1967, it is estimated that institutional investors held, at market value, around $130 billion of stocks, and in the last decade their net acquisitions of stocks have exceeded in value the net issuance of new stock by all corporations combined.

It is with regard to this area of equity investment by the institutional investors that our knowledge is now the most severely limited. A study of this subject would presumably require the collection of statistics from the institutions that would reveal much more than is now known about the extent and character of their equity holdings, and of the volume and pattern of their trading in the equity markets. We would support such a program of data collection. Analysis of the results should help to clarify the differences in investment objectives that exist among institutions and as between the institutions and individual investors, and permit exploration of the economic implications of these differences.

The rapid expansion of institutional participation in the equity securities markets also raises important structural questions that need investigation—questions that bear on the efficiency with which our financial system continues to serve the needs of the U.S. economy. For example, to what extent have the changing activities of the institutions induced a shift in savings flows into equities rather than debt instruments? Has the increased institutional interest in equities brought a corresponding growth in equity financing by corporations? If not, what are the impediments to increased equity financing, and what can be done to foster a better meshing of the supply and demand for the two major classes of securities—debt and equity? And what are the implications of increasing institutional investment in equities, both for the structure of the securities markets and for the availability of financing to the various classes and sizes of business enterprise?

Answers—or at least informed judgments—should flow out of the proposed SEC study, and would greatly enhance our understanding of financial flows in the American economy. The Federal Reserve System will be happy to cooperate to the extent that we can with the Securities and Exchange Commission in such a study; we will be especially interested in helping to obtain needed information relating to bank trust departments under our supervision, and in participating in other aspects of the study for which we have any special competence.

Mr. Moss. We thank you for your appearance.

In the event any questions should be developed, we will communicate them to you. We would appreciate a very prompt response because the committee is anxious to act on this legislation.

Mr. Robertson. We will be glad to do so, sir.

Mr. Moss. Our next witness is Mr. Richard B. Walbert, president of the National Association of Securities Dealers.

We welcome you.

It is quite obvious that your statement is brief. You may therefore wish to deliver it more or less verbatim.

STATEMENT OF RICHARD B. WALBERT, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS

Mr. WALBERT. Mr. Chairman, we support and offer our full cooperation on both of these proposals.

The summary will probably take longer than the statement because it is so brief, but I will be glad to file it if you prefer it that way.

Mr. MOSS. Following your wishes, if you would like to file it, it will be received for the record at this point.

Mr. WALBERT. Fine; we will file it.

(Mr. Walbert's prepared statement follows:)

STATEMENT OF RICHARD B. WALBERT, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., ON H.R. 7696 AND HOUSE JOINT RESOLUTION 946

I am Richard B. Walbert, President of the National Association of Securities Dealers, Inc., a national securities association registered under Section 15A of the Securities Exchange Act of 1934. We support H.R. 7696 and H.J. Res. 946 and support their passage by this Committee because of their great import to our membership which consists of approximately 3,700 dealers most of whom are engaged in over-the-counter securities transactions.

H.R. 7696, MARGIN REQUIREMENTS FOR OVER-THE-COUNTER SECURITIES

As this Committee is aware, margin requirements for over-the-counter securities were recommended by the Special Study of the Securities Markets in 1963 and this recommendation has been supported by the Board of Governors of the Federal Reserve System. We are confident that adequate criteria can be established by the Federal Reserve Board for the selection of those over-the-counter securities which should qualify for margin lending. We expect to cooperate with the Board fully in this endeavor.

It should be understood, however, that of the estimated 25,000 securities traded in the over-the-counter market, only several hundred will probably be of the type which will qualify for margin privileges. In addition, there appears to be small interest on the part of our members, who presently do not maintain margin facilities, for authority to margin over-the-counter issues. It is our opinion that this lack of demand is because of the expense involved in establishing margin facilities and because of the more complex bookkeeping and recordkeeping problems presented. We mention this since it should be clear that we do not foresee a vast movement of our members to margin trading in over-the-counter securities as a result of passage of this bill. Nonetheless, we believe the bill is consistent with the general scheme of security credit regulation and support its passage.

We believe that it is of the utmost importance that appropriate exemptions from the credit regulation of the bill should be afforded to over-the-counter market makers who finance their markets through bank borrowings, and that no restrictions should be placed upon market making dealers who may wish to extend margin credit to customers in the same securities in which they make markets.

H.J. RES. 946, EFFECT OF INSTITUTIONAL INVESTORS

We fully support the enactment of this bill authorizing an economic study of institutional activity in the securities markets. It is clear to us that adequate information in respect to the institutional effect on securities markets is not available and only through a study such as is contemplated by this bill may it be obtained. It is our belief that the contemplated study should be accomplished through consultation with all interested parties and we urge the Committee to add to the resolution a new section providing for consultation with an Advisory Committee such as is described in S.J. Res. 160.

We appreciate the opportunity of appearing before the Committee and will be pleased to answer your questions.

Mr. MOSS. I would observe that I agree with the third paragraph of your statement and I think that agrees with the views of the sponsoring agency.

Mr. WALBERT. That is my understanding.

Mr. MOSS. Mr. Keith, do you have any questions?

Mr. KEITH. I note in the comment you make on House Joint Resolution 946, you suggest that the committee add to the resolution a new section providing for consultation with an advisory committee that was incorporated in the Senate resolution.

Was that, as was reported out and passed, on the Senate side?

Mr. WALBERT. Yes, sir.

Mr. KEITH. Do you have any preconceived notions as to what this study might reveal that might perhaps be noted at this time?

Mr. WALBERT. Only to say, Mr. Keith, that we share the belief, of I believe everybody else involved here, that there is a great need for this study and for this information but we have no preconceived ideas of what we may find or what may be found.

Mr. KEITH. It is my understanding that very recently there has been, in the course of a day, in a widely held listed security an appreciation 1 day of 20 percent and a movement of hundreds of thousands of shares in that stock.

Can you shed any light on how the speculation in that stock might be dampened legitimately in the public interest?

Mr. WALBERT. Our position, I think, is a little different than the exchanges in this area.

I believe the study will be involved primarily with the listed stocks. As you know, our organization is concerned with the over-the-counter stocks. The majority of activity by institutions is in the listed area. There is some interest obviously in over-the-counter securities. To that extent, we expect to be helpful.

I do not have any particular answer for you on that particular question as to the changes in prices over a day's period.

Mr. KEITH. Thank you very much.

Mr. WALBERT. I do want to clarify that last statement.

As I say, we stand ready to be helpful any way we can.

What I wanted to point out was that the primary activity, which I believe this study will be concerned with, is listed securities because that is where the major part of the activities of the institutions take place.

To the extent it does get into the over-the-counter area of course we will be anxious to be helpful there. I am sure that the study will include over-the-counter activities.

Mr. KEITH. I would hope that it would. I would think it might be easier to accomplish. The kind of speculation I mentioned was an over-the-counter transaction. Generally speaking, the amount of stock outstanding I believe is somewhat less in the over-the-counter than the exchanges; is that not so?

Mr. WALBERT. We have an estimated 25,000 different securities traded.

Mr. KEITH. I am talking about the individual issues in which speculation might be involved.

Do you think it is easy to do?

Mr. WALBERT. I would not think so since our markets in the securities that might be subject to that are spread out over the country to some extent and spread out over many different market makers as opposed to the one central area where listed stocks are traded.

I think, offhand, it might be somewhat more difficult to accomplish day-to-day changes in price in over-the-counter securities than with listed securities.

Mr. KEITH. You mention the fact that you have such a widespread market or places of doing business. I think that, in itself, is sort of an inhibiting factor. Perhaps one would think that maybe additional exchanges, regional exchanges, might be one concept that would lessen the capability of speculation that we are concerned about here.

Mr. WALBERT. I do not feel qualified to answer that, Mr. Keith. There would be a lot of questions involved in something like that. I do not believe it would be an easy thing to advance.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. Moss. Thank you very much, Mr. Walbert.

Mr. WALBERT. We appreciate the opportunity, Mr. Chairman, to participate.

Mr. Moss. The next witness will be Mr. Ralph S. Saul, president of the American Stock Exchange.

You may also desire to file your statement and summarize or you may read it verbatim, whichever suits your convenience and purposes.

Would you identify for the record the gentlemen accompanying you?

STATEMENT OF RALPH S. SAUL, PRESIDENT, AMERICAN STOCK EXCHANGE; ACCOMPANIED BY PAUL KOLTON, EXECUTIVE VICE PRESIDENT; AND JAMES W. WALKER, JR., SENIOR VICE PRESIDENT

Mr. SAUL. Thank you, Mr. Chairman. I will read some of the highlights from my statement.

I am accompanied today by Paul Kolton, executive vice president of the exchange, and James W. Walker, Jr., who is senior vice president of the exchange.

It is a great pleasure to appear before this subcommittee.

The American Stock Exchange wholeheartedly supports House Joint Resolution 946 which authorizes a study of institutional activity in the securities markets. We believe this legislation could have far-reaching significance for public investors.

Seven years ago, this subcommittee sponsored House Joint Resolution 438 which authorized a study by the Securities and Exchange Commission of the adequacy for the protection of investors of the rules of national securities exchanges and national securities associations. That legislation resulted in the special study of securities markets which was transmitted to this committee in 1963 and which provided the basis for the Securities Acts Amendments of 1964.

The special study dealt primarily with the adequacy of rules and regulations governing securities markets which were only beginning to feel the impact of the institutional investor. One of the chapters in the study dealt with the impact of the institutions upon the markets. However, the study's conclusions and recommendations were limited because its primary objetcives were in different areas and because the institutional investor had not yet become as important a factor in the markets.

Changes in the securities markets have moved at a rapid pace since the Commmission's special study report to the Congress. In fact, there is reason to believe that the nature and structure of the securities industry is changing as more people and more institutions make increasing use of the industry's facilities.

Our focus is upon trends discernible today that could create significant problems for the public markets tomorrow.

In considering a study of institutional impact on the markets, it is important to stress that most institutions today follow prudent investment policies which have not created problems in the past. Among some institutions, however, an emphasis on performance has been increasingly apparent and this may become a growing factor in the future.

The growth in the number and size of institutional portfolios appears to be accelerating. For example, it was recently reported that over 60 new mutual funds were in registration at the Securities and Exchange Commission and more than 50 have come to market in the past 18 months.

An insurance company executive has predicted that every one of the 25 largest life insurance companies will be offering variable annuities within 5 years. As the subcommittee knows, variable annuities are an equity product.

Many insurance companies are already in the mutual fund business. Banks are now seeking entry into the mutual fund business, a business from which they are now barred by the public policies incorporated in the Glass-Steagall Act.

Another related phenomenon is the emergence of the so-called hedge fund or investment partnerships formed for the purpose of short-term trading in securties.

In view of the accelerating developments in this area, we believe it is a matter of great public interest that the study be undertaken by the Securities and Exchange Commission.

In order to be helpful to the subcommittee, we would like to review some questions which we think the study should explore.

The first of these relates to the impact of institutional investing upon the existing regulatory structure of the securities markets. We now have a system under which most broker-dealers throughout the country are subject to self-regulation and the self-regulatory agencies are, in turn, subject to oversight by the Securities and Exchange Commission.

Whether one is subject to regulation under the Federal securities laws is dependent upon whether a person falls within the definition of an exchange member or a broker-dealer as defined by the Exchange Act. If a person does fall within any of these definitions, he becomes subject to a complex set of regulations imposed by the Securities and Exchange Commission and the self-regulatory agencies—the exchanges or the NASD.

These regulations spell out responsibilities and obligations of professional broker-dealers to their customers, to the marketplace which they use, and to the investing public.

Institutional investors with significant portfolios are, of course, responsible to millions of investors. They have become large users and have great impact upon our marketplaces. Yet, the obligations of these professional investors are not defined by any statutory responsibility to the marketplaces upon which they depend for liquidity and performance and which they share with millions of small investors.

Thus, it does seem to us that the study should examine whether responsobilities and obligations to the securities markets should be assumed by institutional investors.

The securities markets are the most sensitive of all the financial markets. Because they are sensitive markets, the Congress has subjected them to a high degree of regulation.

I might add here that they also serve as the pricing mechanism for institutional portfolios and, of course, for the valuation of collateral held by banks. It is also important to note that these markets serve as a pricing mechanism, for the calculation of taxes.

Therefore, it is appropriate to consider whether all those who have a major impact upon these markets should be guided by the underlying principles that govern the operations of the securities markets.

The principles that now govern broker-dealers and member firms cover such matters as restrictions upon excessive dealing in the market and the use of credit, reporting requirements, codes of conduct designed to insure fair dealing, and specific standards for supervision and control of trading practices.

The growth of institutional portfolios has also had an impact on the liquidity of our marketplace. The exchange has responded in a variety of ways to provide liquidity for the institutional investor. Exchange specialists, floor and office brokers have developed techniques for handling sizable transactions efficiently.

Special techniques have been developed for acquiring or disposing of blocks—techniques that do not disrupt the auction market and permit the prompt execution of block orders. Member firms have brought additional capital into the market to facilitate the execution of institutional orders.

There are two elements of our central auction markets which provide the liquidity necessary for the proper functioning of those markets: One is the steady flow of round lot orders on both sides of the market; the second is the specialist system. For these markets to work in the manner in which portfolio managers want them to work, there must be broad participation by individual investors.

I wish to emphasize that the auction markets depend upon the flow of small round lot orders. To have participation by individual investors, there must be confidence that the marketplace does, in fact, serve individual investors.

The pressures to perform upon institutional portfolios have placed enormous demands upon our specialist system.

On the American Stock Exchange, for example, participation by specialists for their own account where they deal as principals, in all transactions has risen from approximately 10 percent in 1962, when volume averaged 1.2 million shares a day, to 18 percent 8 days ago when volume reached 10.8 million shares. Thus, the specialist provides the continuing link that balances out buying and selling pressure.

Against this background of greater institutional participation must not the study consider the effect on individual investors of the impact of large-scale institutional activities which they share with many small investors?

We think there is one final matter which should be explored in the study authorized by the resolution. Financial institutions have entered the securities business. Institutions have become members of certain exchanges. We believe that important questions of economic policy are involved in this march of events. The Exchange Act was enacted to regulate securities exchanges whose memberships were composed of professionals providing specialized services, such as brokerage, distribution of securities and investment advice.

The exchange believes, therefore, that the question of who should or should not be in the securities business should be examined. It would be unfortunate if the study does not focus on these questions of national economic policy.

In summary, the Nation's securities industry is at another historic crossroad. It is characterized by growing participation among millions of individual investors and thousands of financial institutions, and it is anxious to respond to the needs of both.

This subcommittee is considering a pioneering study of institutional activity in the market. The American Stock Exchange strongly supports this proposal and believes it will be most productive if the study also focuses on these four points:

(1) Whether responsibilities and obligations to the securities markets should be assumed by institutional investors,

(2) What impact has growing institutional interest in the securities market had and what impact is it likely to have on the liquidity of those markets,

(3) What safeguards are required for the individual investor in light of the growing importance of institutional investors, and

(4) What questions of national economic policy are involved in institutional membership in the securities industry.

In view of the importance of the study to the investing public, the exchange believes that the subcommittee should assure itself that the appropriation requested is adequate.

Also, the exchange feels that the creation of an advisory committee provided for by the Senate resolution would be an important addition to the project, insuring that the study authorized by the House resolution includes the expertise of additional segments of the financial community.

Mr. Chairman, I have two additional points that are not in my prepared remarks.

One, I would like to say that I concur in the observation of Congressman Keith that if the study reaches interim conclusions before its completion, that these interim conclusions or recommendations should be brought to the attention of the subcommittee and the public.

The final point I would like to mention is that the American Stock Exchange supports H.R. 7696, and we concur in the statement of Governor Robertson.

Thank you very much.

Mr. Moss. Thank you very much, Mr. Saul.

I want to compliment you on an excellent statement, one that is consistent with the very fine record that you have, both as president of the American Stock Exchange and as one who played a very important role in the previous studies.

I concur in the observations made, particularly the four points stressed on page 6 of your statement.

I also am of the hope that the authorization which the committee votes will be adequate to do the job because the job is urgently needed.

I want to reassure you that it is the committee's intention to maintain its appropriate legislative oversight function and to make certain that any interim conclusions are brought to the public's attention.

Mr. SAUL. Thank you very much, Mr. Chairman.

Mr. MOSS. Mr. Keith.

Mr. KEITH. I join the chairman in complimenting you on the presentation here.

Although I do not have any firsthand knowledge, I have read in the papers about the excellent job you are doing for the exchange which you head.

You say:

> For these markets to work in the manner in which portfolio managers want them to work, there must be broad participation by individual investors. To have that participation there must be confidence that the marketplace does, in fact, serve individual investors.

Do you believe that if the institutions speculate in this marketplace, that unsophisticated buyers, who constitute the great majority of the American investing public, are going to be lacking in confidence in that marketplace, what makes it move, and they are going to give their business more and more to the institutional buyer because trading is too complicated for them to understand?

You get to a point where the two-fifths becomes three-fifths, four-fifths, and only the individual investor with extraordinary wealth and research capabilities can afford to enter the den.

We must find some way to inhibit that development.

I am glad you read your entire statement. I think it will be helpful to us in motivating our colleagues to act with speed, and favorably so, on this subject. To my way of thinking, it is a most important presentation.

Thank you, Mr. Chairman.

Mr. MOSS. Thank you, Mr. Saul, and your associates. Your statement has been helpful to the subcommittee. It will be helpful to us in our markup session on this legislation.

Mr. SAUL. Thank you, Mr. Chairman.

Mr. MOSS. The Chair would like at this time to recognize the presence in the hearing room of the former chairman of this subcommittee under whose direction the previous study was initiated, former Congressman Peter Mack.

Mr. MACK. Thank you, Mr. Chairman.

Mr. MOSS. Our next witness is Mr. Donald L. Calvin, vice president of the New York Stock Exchange. He is accompanied by Mr. Stan West, director of research.

STATEMENT OF DONALD L. CALVIN, VICE PRESIDENT, NEW YORK STOCK EXCHANGE; ACCOMPANIED BY STAN WEST, DIRECTOR OF RESEARCH

Mr. CALVIN. Thank you, Mr. Chairman.

We actually have little to add to what has already been said on H.R. 7696. So, with the Chair's permission, I would suggest that the statement be filed as part of the record.

Mr. MOSS. If there is no objection, your statement in support of H.R. 7696 will be included in its entirety in the record at this point.

Mr. CALVIN. With respect to House Joint Resolution 946, again, the New York Stock Exchange does support this resolution.

In brief, it is our view that there is a need for an institutional study, that the Securities and Exchange Commission is the proper organization to undertake that study, and that the New York Stock Exchange and the securities industry is willing and expects to work with the Securities and Exchange Commission in developing the type of study which is needed. By so doing, we are really reiterating the support for the studies that was stated in Mr. Robert Haack's—the president of the exchange—letter to you, Mr. Chairman, of March 12 of this year.

In that letter, we sought to apprise the committee of our accord with the view of Chairman Cohen of the Securities and Exchange Commission on their proposed study as outlined in Chairman Cohen's letter to Mr. Haack on February 14. There is little more than we can really add to what has been said this morning.

So, again, with the Chair's permission, I would offer this statement to be filed on House Joint Resolution 946 for the record.

Mr. MOSS. Without objection, the statement will be included in its entirety at this point in the record.

(The statement referred to follows:)

STATEMENT OF THE NEW YORK STOCK EXCHANGE, ON H.R. 7696

The New York Stock Exchange supports H.R. 7696.

Simply stated, our support for this bill is based on the proposition that the public should be permitted the ease and convenience in purchasing quality over-the-counter securities on margin through their borkers as it now enjoys when purchasing listed securities.

This bill would amend Section 7 of the Securities Exchange Act of 1934 by granting the Board of Governors of the Federal Reserve System authority to permit broker-dealers to extend credit on unlisted securities. H.R. 7696 would also permit the Board of Governors to impose margin requirements on bank loans extended for the purpose of purchasing or carrying unlisted securities. We are familiar with the provisions of the bill and with the letter of March 1, 1967 from Chairman William McChesney Martin to Senator John Sparkman, which endorses extension of margin regulations to selected unlisted securities.

The bill follows from one of the recommendations of the 1963 Securities and Exchange Commission Special Study of Securities Markets. The Special Study surmised that broker-dealers were prevented by Section 7 from extending credit on unlisted securities because in 1934 it was presumed that markets for securities traded over-the-counter were illiquid and that reliable and current prices could not be established for them. Thus margain requirements based upon a percentage of the market value for these securities could not easily be established or regulated.

However, the Special Study went on to note that in recent years a significant number of companies whose securities are traded in the over-the-counter market enjoy both the operating record and market maturity of many listed securities. The Special Study concluded its discussion of the topic by observing that, among these companies, there could be identified "those issues equal to or more nearly approaching listed issues in activity, trading depth and ready availability of reliable price information and it would appear to be desirable to place such issues on a par with listed issues for margin purposes and to entrust the establishment of standards and procedures for that purpose to the FRB."

The New York Stock Exchange has for some years advocated the expansion of margin regulations to include extensions of credit by broker-dealers and banks on unlisted securities traded over-the-counter.

In his letter of March 1, 1967, Chairman Martin indicated that, if H.R. 7696 is enacted, the Federal Reserve Board of Governors intends to select a limited number of unlisted issues which have the requisite market characteristics and impose margin requirements on loans for the purpose of purchasing or carrying the selected securities. We support this proposal.

There are a number of qualified companies which, for a variety of reasons, elect not to list on a national securities exchange. Generally, the markets for their securities are active and orderly. Investors can obtain accurate and timely information concerning these companies. Presently, the National Association of Securities Dealers suppliers bid and ask prices to newspapers, radio, television and other media through a National Committee and network of 122 local quotations committees. These committees are composed of experienced representatives of NASD member firms who compile daily quotations tables corresponding to the interests of the public investors in the area.

The NASD also recently announced a comprehensive plan to develop an automated quotation system for the over-the-counter market.

Envisioned is a highly technical and complex project involving the use of electronic data processing equipment in combination with communications facilities to eventually produce a three-level system responsive to 350,000 inquiries in any given eight-hour trading period and designed to aid registered representatives, customers, order desks and professional traders in the OTC markets.

This project will represent not only a significant advance in the information available to brokerage firms and their customers through the more than 25,000 interrogation display units now in use but will allow the NASD to supply more current price information to newspapers and other media. The bid and ask prices now being published will be replaced by more timely quotations and will include volume data as reported by firms participating as market makers in the automated system.

Equity will be served by removing the double standard which now permits some financial organizations to extend credit to purchase or carry unlisted securities but prohibits others from doing so. As the SEC Special Study indicated, the reasons for establishing this distinction in 1934 are no longer applicable to those unlisted companies whose securities today enjoy a market stability comparable with that of listed companies.

The staffs of the New York Stock Exchange and the Federal Reserve Board have discussed some of the problems involved in formulating the regulations which will be issued by the Board of Governors if H.R. 7696 becomes law. We shall, of course, continue to offer our assistance on this question. In addition, we intend to discuss with the staffs of the SEC and the Federal Reserve Board the suggestions of the SEC, noted in Chairman Martin's letter that dealers making markets in particular unlisted securities should be restricted from selling such securities on margin because of possible conflict of interest. We are strongly opposed to that suggestion because, in our view, such a restriction would be inimical to the interests of investors as it would force the OTC market makers who carry customer accounts to choose between making a market and extending margin credit, which almost inevitably would result in a decision to withdraw as market makers. In so doing, the capital provided by these firms in their market-making function would similarly be withdrawn to the detriment of public investors dealing in OTC securities and to the detriment of other broker-dealers including those firms, not carrying customer accounts, who would continue to make markets. The result would be wider spreads in the quotations in the marginable OTC securities, less depth in the market in these securities, and a lesser ability of the continuing market makers to absorb stock in times of market stress.

We see no conflict of interest in permitting market makers to extend credit to its customers. We expect that the type of OTC securities which will be eligible for margin will have sufficient investor interest to offer assurance that no one market maker can dominate the market in a manipulative way. If a market maker does, in fact, manipulate the market, existing provisions of the Securities Exchange Act of 1934 give the SEC ample authority to deal with the situation.

We are, however, in general agreement with the approach the Federal Reserve Board indicated in its statement to the Senate Banking and Currency Committee at the Hearings on S. 1299—the Senate companion bill to H.R. 7696—that it intends to follow in developing the specific standards which would determine the OTC securities to be included under margin requirements.

On pages 7 and 8 of Governor J. L. Robertson's statement to the Senate Banking Committee, he stated as follows:

"S. 1299 permits the Board to develop specific standards which would determine the securities that should be covered. This would be done by regulation, and industry comments and suggestions would be solicited through advance publication of the proposed rules. The Board's intention would be to develop standards that will encompass within the ambit of margin regulation those OTC stocks which have market and investor characteristics similar to those of exchange-traded stocks.

"The Board's initial task will be to develop indexes of present and prospective market behavior to be applied to individual issues, based on such factors as the number of shares outstanding, number of stockholders, assets and earnings of the issuer, continuity of market price quotations, number of dealers that make markets in the issue, indicated volume of trading, and other factors. As already broadly stated, these measurements would be designed to limit the list of OTC securities to be included under margin requirements to those issues that are the most active, and that would meet most, if not all, of the prerequisites for exchange listing."

We are willing to work with the Federal Reserve Board in developing the specific standards. The New York Stock Exchange has considerable experience in this area because of the development and continual review of the Exchange's own listing and delisting standards for companies seeking or retaining a listing of their shares on the Exchange. The Exchange listing and delisting criteria have been revised 5 times in the last 10 years.

The Committee might be interested in some statistics on margin credit on listed securities. In recent months the amount of credit used in customers margin debt has risen in keeping with the increase in volume of trading. During the month of April stock margin debt rose by $190 million to a record total of $6.38 billion. This compares with a total of $5.09 billion in April of 1967. More detailed data are shown in Appendix Table A. Statistics showing the effect, if any, of the recent Federal Reserve Board action increasing margin rates will not be available for another month.

While also not directly related to H.R. 7696, we recognize that the Committee may be interested in the high levels of activity in the securities market and the problems which this activity creates. In a letter to the membership, dated June 6, 1968, Mr. Robert W. Haack, President of the New York Stock Exchange, outlined the nature of the problem, pointed to a series of measures on which the Exchange is moving ahead that are designed to assist member organizations in the operations area, and suggested a number of voluntary restraints which individual firms might consider depending on the nature of their problems. A copy of this letter is attached as Appendix B.

Among the steps which the Exchange is taking to ease current operations problems is the activation of the Central Certificate Service, a joint industry project in which the Exhange is working with New York clearing house banks in areas of mutual concern, an extension of the delivery period from four to five days and the development of a fail clearance program.

The nine suggestions for voluntary restraint on the part of individual member firms were based on the idea that it makes little sense today to develop business that a firm's operations departments cannot handle. These suggestions, therefore, were primarily designed to dampen sales and promotion activities and to speed the processing of paper work.

There is one further point which should be mentioned. Although H.R. 7696 would amend Section 7 of the Securities Exchange Act of 1934, Section 11d–1 of the same statute might nonetheless be interpreted to bar the Federal Reserve Board from utilizing the rule-making power granted in the bill to permit the extension of credit on mutual fund shares which are unlisted securities and would otherwise be covered by the bill. This possibility arises from the fact that because a mutual fund offers its shares to the public these shares may technically be regarded as part of a "new issue." Section 11d–1 prohibits the extension of credit on any securities which are "part of a new issue" under certain circumstances. The legislative history of this bill should make it clear that Section 11d–1 should not be interpreted to cover the shares of a mutual fund where the fund has been offering its shares on a regular and continuous basis since it is only as a technical matter that its shares may be viewed as part of a "new issue." There is no reason to distinguish mutual fund shares from other unlisted securities for purposes of the bill.

In summary, we believe this bill recognizes the differences between securities markets today and 1934 and will benefit investors while protecting them from indiscriminate application of margin regulations to the over-the-counter market. Accordingly, we endorse H.R. 7696.

Appendix A

HISTORICAL DATA—MARGIN ACCOUNTS

[Dollars in millions]

	Debt	Registered and exempt collateral	Credits	Potential purchasing power	Number
1968:					
April [1]	$6,380	$25,170	$980	$8,120	885,000
March	6,190	22,240	980	7,900	865,000
February	6,150	22,290	990	8,250	860,000
January	6,150	23,820	950	8,200	850,000
1967:					
December	6,310	25,060	910	7,980	840,000
November	6,090	23,770	840	7,520	805,000
October	6,020	23,690	810	7,720	800,000
September	5,810	23,500	740	7,650	785,000
August	5,620	22,820	700	7,210	770,000
July	5,490	23,120	720	7,280	760,000
June	5,360	21,550	710	7,310	750,000
May	5,160	20,500	760	7,170	730,000
April	5,090	20,990	670	6,990	720,000

[1] Preliminary. Also, does not include new bond commitments.

DEFINITIONS AND TECHNICAL NOTES

This report is based on data collected by the New York and Midwest Stock Exchanges from over 380,000 margin accounts. It represents almost 50% of all customer margin debt carried by NYSE member organizations. The sample includes all of the very largest and a representative sample of the medium-sized and smaller firms.

Margin debt

The money owed NYSE member firms by customers through margin accounts. Unlike the customers' net debit balance series, these data *exclude* balances in special subscription, non-purpose loan, commodity and cash accounts. These exclusions eliminate the influence of non-margin account debt, particularly temporary cash account debits, in the nature of receivables arising from purchases awaiting payment.

Registered and exempt collateral

Listed stocks and bonds held by NYSE member firms to secure the debt in margin accounts. Included are bonds of the U.S. government, state and political subdivisions, but because full security value cannot always be calculated for bond positions in this report, total Registered Collateral is understated slightly.

Potential purchasing power

Estimated funds currently available in the accounts of margin customers to purchase additional securities at present initial margin requirements while maintaining minimum equity.

Number of margin accounts

The total number of margin accounts in debit or credit status at NYSE member firms.

APPENDIX B

NEW YORK STOCK EXCHANGE,
New York, N.Y., June 6, 1968.

To: Members and allied members.
Subject: Member firm office operations.

The record trading volume of April and May has led to understandable concern in the securities industry as to how member firm offices are coping with the renewed pressure of paperwork.

April's record total of 295.6 million shares on the New York Stock Exchange was followed by a May volume of 292.1 million shares. In the last week of May, the average combined activity on the New York and American exchanges totaled more than 20 million shares a day, and in the first week of June, these levels were surpassed. Indications are that activity on the over-the-counter market has risen at least on a comparable basis.

Comprehensive data on fails are now available as a result of new reporting requirements of the New York and American exchanges. In brief, the first of the monthly fail reports showed at the end of April that:

Fails to deliver at the end of April totaled approximately $2.6 billion.

In relation to the record levels of mid-January, this represented a decline of 24 percent; compared with March, however, the end of April figures indicated an increase of 30 percent in the month. Volume during April rose 61 percent above January volume.

On a dollar basis, about 46 percent of all fails, and 60 percent of those over 30 days of age, were over-the-counter securities.

On an item basis, a total of 58 percent of all fail items, and 81 percent of those over 30 days of age, involved over-the-counter securities.

New York Stock Exchange fails on a dollar basis amounted to 37 percent of all fails and 25 percent of those over 30 days. On an item basis, the fails were 22 percent and 11 percent respectively.

Fails data alone do not illustrate the breadth of potential problems, but these figures do serve as the best single measure of industry backlog. More importantly, this Exchange has instituted a Special Operations Questionnaire to provide detailed information for each member organization carrying accounts on the status of each area of record-keeping, such as general ledger and customer account postings, dividends and stock record, together with related information on overtime, customer complaints, etc. The result, both to the member firm and the Exchange, is a much more precise picture of operational status and identification of problem areas than had been been previously available.

The Special Operations Questionnaire, henceforth, will be regularly required with the Exchange's Short Form Special Financial Questionnaire. *It would seem that Chief Executives* who ask themselves, "What is the condition of my back office?", "Where are our difficulties, and what are we doing about them?", "If my back office is at capacity or in difficulty, what is my firm doing to impose self-restraint on our own volume?", *could use the Operations Questionnaire, or a modification, on a continuing weekly or monthly basis to assess their own condition as an aid to planning and action.*

In light of the continuing operations problems and renewed pressure of volume on back offices, it is the Exchange's belief that firms should seriously consider adopting voluntary restraints on business emanating from problem areas. This applies particularly to member organizations with a large number of open over-the-counter transactions. Fails in unlisted securities—particularly those fails 30 days old or older—comprise a disproportionate amount of outstanding open items.

Depending on the nature of individual firm problems, voluntary restraint might be considered, such as the following:

Cease to solicit over-the-counter transactions;

Reduce or discontinue firm trading, including arbitrage. (Restrict arbitrage to a volume of securities which your firm can borrow to make delivery);

Disallow commission credit on securities selling at less than $5, $7, or $10, or on securities with difficult transfer or delivery problems, or on day trades;

Raise the minimum equity required in margin accounts to $5,000 or $10,000;

Terminate registered representatives who do not strictly observe industry and firm policies;

Increase practice of transferring and shipping customers' free securities;

Reduce advertising and promotion;

Institute or increase penalties on registered representatives procedural errors and failures to obtain timely payment or security deliveries;

Request account delivery instructions from customers who cause operations problems.

It makes little sense today to develop business that a firm's operations departments cannot handle.

The Exchange is moving ahead with a series of measures designed to assist member organizations in the operations areas. Here is the current status of these measures:

Central certificate service.—CCS has begun its limited activation phase and is proceeding smoothly. The late June target for full activation of CCS for eligible issues beginning with A through C—which account for about 30 percent of the Exchange volume—will be met without difficulty.

Mandatory buy-ins.—Rules adopted to provide for mandatory buy-ins if a security has not been delivered within 50 calendar days after the normal settlement date will be effective August 1 for trades of June 12 or older. It is hoped other exchanges and the NASD also will adopt similar rules. The purpose is to encourage firms to borrow stock to complete deliveries and maintain the flow of securities, and thus avoid buy-ins. A special directory of member firms available to lend stock is being compiled by the Exchange and should be available for distribution soon.

Joint industry project.—New York Clearing House banks have agreed to open their safe deposit facilities to brokers to deposit and withdraw collateral loan securities at the uniform hour of 8:30 a.m., an earlier time than most had been open in the past. The agreement was one of the first accomplishments of the newly established Joint Banking-Securities Industry Project. The 56 representatives of the securities industry and banks serving on five committees under the project are working on solutions to a number of other mutual problems to simplify and speed the processing of securities transactions.

Fail clearance.—The American Stock Exchange is conducting a test program of fail clearance. Under this system, old fails are submitted by firms, compared for clearance, paired off, money differences settled—and intermediate deliveries thus eliminated. The experience of the American Exchange, for alphabetical issues A—G, resulted in an average elimination of 40 percent of the fail items included. The New York Stock Exchange will have available a fail clearance for testing with member firms before mid-June.

Information.—Letters and circulars have been sent to member firms containing suggestions on obtaining prompt customer delivery of stock certificates, maintenance of an appropriate ratio between back office personnel and salesmen in recruiting and training plans, the need for accuracy in record-keeping, procedures for safeguarding negotiable certificates such as government bonds, investigation of new operations personnel and margin safeguards.

Five-day delivery period.—Extension of the delivery period from four to five days, authorized in February, has provided a full weekend during the normal delivery period for all "regular-way" transactions. This has relieved pressures on back offices, including some from outside causes, such as postal delays.

Restrictions.—Starting in January, member organizations were put on notice that those whose operations were severely impaired by paperwork problems would be required to limit the expansion of their business, or to reduce the level of their business, to a point that could be handled. Member organizations which have been subjected to restrictions must report on the Special Operations Questionnaire monthly or more frequently if the circumstances warrant. As a result, the Exchange intensifies its oversight of such firms both in the operations and capital areas. It has been the practice of the Exchange in administering restrictions initially to limit office openings and additions to sales staffs. If necessary, restrictions are expanded to require discontinuance of advertising and promotion, firm trading, market making and underwriting, solicitation of over-the-counter transactions, sale of branches, etc. Appropriate restrictions may be extended to such a firm's correspondents.

The object of the Exchange's efforts in this area is to effectively identify individual firms with problems at a significant level. Once identified, steps can be taken to require correction of the operational difficulties before they become so critical as to affect customers or other member organizations. It is the hope that such a procedure can properly penalize the firm which has not properly managed its own growth without inflicting an unwarranted penalty on the remainder of the industry.

The measures described in this letter have already had an important operational effect. They have also served to focus the attention of our industry on the importance of keeping abreast of the workload. Until the full effect of longer-range programs—such as CCS—can be felt, it is crucial that the Exchange and its member firms continue to give the most urgent attention to improving its operations capacity. A "business-as-usual" attitude is a luxury that the industry can no longer afford. I know I can count on your cooperation and assistance.

ROBERT W. HAACK,
President.

STATEMENT OF THE NEW YORK STOCK EXCHANGE ON HOUSE JOINT RESOLUTION 946

The New York Stock Exchange supports the proposed study of institutional activity in the securities markets which is authorized by House Joint Resolution 946.

In brief, it is the view of the New York Stock Exchange that there is a need for an institutional study, that the Securities and Exchange Commission is the proper organization to conduct the study, and the securities industry is willing and expects to work with the Securities and Exchange Commission toward developing the type of study that is needed.

We are, in effect, reiterating our support for the study as stated in Robert W. Haack's letter of March 12, 1968 to Chairman John Moss. In that letter, we sought to apprise this Committee of our accord with the views of Chairman Manuel F. Cohen on the proposed study as outlined in considerable detail in his letter of February 14, 1968.

In his letter, Mr. Cohen made it clear that what he has in mind is an economic study, not an investigation. And that the study is intended to produce information concerning basic economic trends that will be helpful—in Mr. Cohen's words—"to the Commission, to the self-regulatory agencies, to the industry and to everyone else concerned with the role of institutions in the securities markets" so that all may be informed as promptly, as currently and as continuously as possible. Further, he stated, and we agree, that the study "is not intended to produce disciplinary proceedings or other enforcement actions against any firms, persons or institutions. Nor would it be used to conduct investigations for any such purpose."

In his letter, Chairman Cohen also discusses the Commission's desire to have an Advisory Committee which would meet regularly with the study staff and with the Commission during and after the completion of the study and "would have an active role in shaping the scope and conduct of the study."

As you know, Senator John Sparkman has introduced, and the Senate has approved, Senate Joint Resolution 160. That Resolution is the same as House Joint Resolution 946 with one major exception.

The last paragraph of Senate Joint Resolution 160 provides as follows:

"In connection with such a study, the Commission shall consult with representatives of various classes of institutional investors, members of the securities industry, representatives of other government agencies, and other interested persons, and with an Advisory Committee which shall be established by the Commission for the purpose of advising and consulting with the Commission on a regular basis on such matters."

We think that this is extremely important in that it makes clear that the Commission will consult with representatives of the securities industry and the other named groups. The SEC has clearly stated that this provision meets with its approval. In his testimony before the Senate Banking Committee on Senate Joint Resolution 160, Chairman Cohen stated that ". . . we intend to work closely with all interested persons, including institutional investors, members of the securities industry, and representatives of other Government agencies. We will establish an Advisory Committee which would participate at all phases, including the development of final conclusions. I note that the last paragraph of Senate Joint Resolution 160 requires that this be done and we welcome this because that was, in any event, our intention. . . ."

We agree that the creation of an Advisory Committee would be most desirable, in fact, vital to making the study truly meaningful. Further, we agree that the role of the Advisory Committee should be an active one, as the language in the last paragraph of Senate Joint Resolution 160 suggests. We, therefore, suggest that the Committee add the last paragraph of Senate Joint Resolution 160 to House Joint Resolution 946.

The table attached as Appendix I contains some recent statistics on the growing importance of institutional activity in our market. The reason for including this table is to emphasize again the need for a study of institutional activity in the securties markets because of the rapidly accelerating growth in institutional activity.

The table compares volume in general on the New York Stock Exchange with large block volume. The main point of the table is that while volume as a whole only rose negligibly (2.4%–3.0%) in the first quarter of 1968 as compared to the first quarter of last year, large block volume was about 50% higher for the same period.

Data for the months of April and May, 1968, which are included in the table show that this trend is intensifying. In the month of May, for example, large blocks were about half the total for the entire first quarter of 1968. In our opinion, these recent figures emphasize the need for prompt Congressional approval of House Joint Resolution 946.

SEC data clearly show that the portfolio turnover of institutional investors, particularly mutual funds, has increased significantly during the past year. Because of the ability of the auction market to handle large block transactions, the growing institutional activity has by and large been absorbed in an orderly manner.

The question of whether the increased institutional activity could at some point be detrimental to the orderly functioning of the securities markets would undoubtedly be a major area to be covered by the proposed study envisioned by House Joint Resolution 946. It is, of course, possible that at some point this trading could increase price fluctuations of listed securities. On the basis of limited analyses, we have found no evidence that this is the case. The report attached as Appendix II by the Research Department of the New York Stock Exchange in November, 1967, entitled "Influence of Institutional Investors on Stock Price Stability" concluded that there was little cause for concern at the moment over any destabilizing impact of institutions.

A definitive answer to the question would require extensive analyses, and the Exchange hopes that the proposed institutional study will undertake such analyses.

A more recent study by our Research Department, which is attached as Appendix III, sought to determine the sources of volume on a single day, June 4, 1968. On this date, volume exceeded 18 million shares and was third highest in Exchange history. On that day 55 large blocks of 10,000 shares or more were traded representing a share volume of 1,312,800 or 7.3% of total transactions for the day. The study concludes that the upsurge in volume on June 4 was apparently accounted for by public individuals because of a relatively large number of trades of 100 and 200 shares. At the same time, public individuals, except for margin accounts, were primarily on the sell side while the purchase side of the market was dominated by institutional investors.

If the letters of March 12 and February 14 to which we have referred are not presently included in the record of these proceedings, it is respectfully requested that they be so included.

Appendix I

TOTAL VOLUME COMPARED TO LARGE BLOCK VOLUME IN THE NEW YORK STOCK EXCHANGE

I. QUARTERLY DATA

	1st quarter 1967	1st quarter 1968	Percent increase
Total volume:			
Reported share volume (millions)	615	630	2.4
Daily average share volume (millions)	9.9	10.2	3.0
Large blocks (10,000 shares or more):			
Number	1,385	1,991	43.8
Shares (millions)	34	50	47.1
Value (millions)	$1,326	$2,034	53.4
Percent of reported volume	5.5	7.9	------

Appendix I—Continued

TOTAL VOLUME COMPARED TO LARGE BLOCK VOLUME IN THE NEW YORK STOCK EXCHANGE—Continued

II. MONTHLY DATA

	April 1968	May 1968
Total volume:		
Reported share volume (millions)	296	292
Daily average share volume (millions)	14.8	13.3
Large Blocks (10,000 shares or more):		
Number	989	1,054
Shares (millions)	25	26
Value (millions)	$1,004	$1,140
Percent of reported volume	8.4	9.0

Appendix II

Influence of Institutional Investors on Stock Price Stability

(BASED ON TWO STATISTICAL STUDIES)

(Prepared by the Research Department, New York Stock Exchange, November 1967)

INTRODUCTION

An increasing number of people have voiced concern this year regarding the alleged destabilizing effect of some institutions on the stock market. Critics have particularly called attention to the impact of the so-called "performance" mutual funds and their penchant for high turnover rates and relatively short-term profits (or losses).

Despite a singular lack of the type of information necessary to permit any clear-cut conclusions, some people have expressed strong and positive opinions that a significant danger exists which apparently did not exist before. These opinions have come most notably from government officials, the press, and corporate officers.

The Research Department, with the help of the Department of Member Firm's Stock Watch Division, has made two statistical studies to develop new information and insight on the influence of institutions on stock prices. These analyses cover only the short-term impact, confined to price action during individual days. They do not measure the influence of institutions over longer periods of time—an impossible task in any case. In any event, short-term forces appear to be of primary concern among those who decry institutional "speculation." Therefore, analysis of a single day's price action is appropriate.

SUMMARY OF RESULTS

1. The first analysis covered over 200 large blocks (10,000 shares and over) transacted on NYSE in early September. Almost half were executed at prices within plus-or-minus one-quarter point from the closing price of the respective issue on the previous day. Almost two-thirds of the blocks traded at a half point differential or less, while over three-fourths were at less than one point change. These figures reveal considerable stability in the Exchange's market pricing mechanism in handling major institutional trades. The results also conform closely to those for a similar study of almost 2,000 blocks in 1964–65.

2. The second analysis involved a tabulation of the reasons behind unusually large daily price changes in individual issues, uncovered by reviews by the Exchange's Stock Watch staff. Only a very small proportion (less than 3%) proved to be of such a nature that institutions might have been a primary factor in causing the price change. Among the influences of far greater importance were corporate news announcements (earnings, new products, tender offers, etc.) and research reports and recommendations by brokerage firms.

3. These findings suggest little cause for concern at the moment over the destabilizing impact of institutions. However, the rising importance of this group of investors requires continuous review to assure not only satisfactory service to them, but also that any developing instabilities do not create serious problems for the specialist system and harm to the investing public in general. This review might include occasional resamplings of Stock Watch data in the future.

DETAILED FINDINGS

Large blocks

For each large block on NYSE during the first two weeks in September 1967, the change was measured from the price of the issue at the end of the previous day to the price of the block itself. The distribution of price changes is shown below:

	Number	Percent
Total blocks sampled	209	100.0
Zero to ± ¼ point	96	45.9
±⅜ to ½	38	18.2
±⅝ to ⅞	24	11.5
±1 point or more	51	24.4

These price changes should not be viewed as resulting from the blocks alone. A block executed at 2 p.m. would show a price change from the previous day's close stemming from the block itself plus all of the volume during the day up to the time of execution. Therefore, these data can only provide a rough approximation of the effect of a block.[1]

The relative importance of these blocks in accounting for a total day's volume in each issue varied widely. In one case, it was less than 2%; in another case, a block accounted for 99%. The price impact sometimes reflected these differences, but the data show a large number of exceptions.

Considering the time span between the close of the previous day and the execution of the block, these figures demonstrate a high degree of stability for the bulk of the transactions. The fact that 46% were made within plus-or-minus one quarter point, 64% within a half point, and over 75% in less than one-point suggests that the market is capable of handling blocks with minimal impact on price.

These results for the more than 200 blocks are close to those for an earlier and much larger tabulation covering all blocks (1,971) from the fourth quarter 1964 to the third quarter 1965. Among these blocks, 50.7% (exactly 1,000) had price changes of plus-or-minus one quarter point or less from the *opening* price on the same day as the block. The slight lower quarter-point ratio for the September 1967 sample—46%—is not surprising, because the change from the previous day's close would tend to be somewhat greater on average.

Stock Watch data

Each day, NYSE computers produce a list of issues which show unusually large net price changes from the previous day's close. An issue appears on the list if its price change falls within a predetermined schedule of price changes for different price ranges.

The Stock Watch staff looks into each issue noted until a sufficiently clear picture is developed as to why the price change may have occurred. These reviews are generally not exhaustive unless further investigation is warranted; but they are carried far enough to assure the staff that nothing illegal nor unethical took place. (In a few cases, a review may reveal no clear cut reason for the price action. But the buying or selling is widespread or scattered among so many member firms as to indicate a general interest by a large number of customers and thus is nothing warranting special concern.)

To measure the importance of institutions relative to other influences causing issues to be noted by the Exchange's computers, the results of all Stock Watch reviews for the third quarter 1967 were tabulated. These are shown in the table on the following page.

A word of explanation about the role of institutions:

1. In 2.9% of the 1,260 reviews, heavy buying by at least one major institution was found with the issue rising in price—or heavy selling in a price decline. Therefore, the table describes institutional activity as "might have been (the) prime influence in (the) price movement." The phrase "might have been" is used for reasons mentioned in the Discussion section on page 5.

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[1] An alternative approach would be to measure the price change of a block from the last sale. However, this difference is often of no significance, because both the block and the previous sale frequently are part of the same order from a single customer.

2. In 14.6% of the reviews, significant institutional activity took place. This was indicated by the fact that much of the volume stemmed from customers of member firms specializing in such business. The firm often had issued a research report which created the interest. But in none of these cases was any evidence found of an *independent* decision by a major institution to buy or sell playing an important part in the day's activity. (An exception might be a large *sale* in a *rising* market or vice versa—a situation clearly not falling under point 1 above.)

3. Institutional activity may have occurred under any of the other types of influences shown in the table. But the prime factors were as shown, affecting customers of all types. No reason exists for believing that the results of any such influences would have been greater or slighter with or without institutions.

The conclusion from this tabulation is that a multitude of forces cause sharp price changes on the Exchange each day. This is to be expected in any stock market. Institutional activity unquestionably is one of the forces, but it is not apparently important enough to warrant the degree of criticism frequently made.

DISTRIBUTION OF SPECIFIC INFLUENCES BEHIND DAILY SHARP PRICE CHANGES IN INDIVIDUAL ISSUES, THIRD QUARTER 1967

	Number	Percent
Total	1,260	100.0
Institutional activity:		
Heavy buying or selling by major institution(s) which might have been prime influence on price movement	37	2.9
Significant institutional activity, but no evidence of important influence on price movement by any major institution	184	14.6
Other influences:		
Change in earnings, new data	196	15.6
Announcement, re acquisition, merger, or tender offer	170	13.5
Heavy buying or selling by many customers of 1 or a few firms, principally due to member firm (noninstitutional) recommendation	306	24.3
Change in economic conditions affecting company:		
Price of company product	34	2.7
Statement, re sales expectations	12	.9
New product(s)	19	1.5
Other	35	2.8
Investment advisory service recommendation	5	.4
Other, including no explanation	262	20.8

Source: Division of stock watch.

DISCUSSION

These analyses are intended to place the influence of the institutional investor in proper perspective in relation to all other forces in the market. They do not deny that the institutional investor is a significant element. When institutions and intermediaries account for one-third of the Exchange's volume, their influence cannot be ignored. If they should become a substantial destabilizing force, they could place a large burden on the specialist system. But, the Stock Watch data in particular indicate that such burdens are minor compared to those created by other factors.

Measuring price impact

One problem in reaching conclusions on this subject is that it is not possible to *measure* directly the price impact of an single influence. Take the following hypothetical situations:

1. An institution sells a large block at a price below the last sale. If the price shortly thereafter rises back to its previous level, what was the real impact of the trade?

2. Such a block is crossed at no change in price, but the stock declines after the cross. Did the cross cause the decline or not?

3. An institution sells a block in several pieces, none of which is at any change from its respective last sale. But word gets around that an important sale is taking place, thereby causing a price decline as other investors sell. To what extent was the sale by the institution a direct or indirect cause of the price drop?

The point is that prices change under the impact of a complex psychological structure of motives, expectations, knowledge, lore and beliefs, not to mention "tips and rumors". The importance of psychology cannot be over-stressed. The large number of so-called chart readers who watch for visual patterns on a piece of chart paper, for example, can conceivably produce whole chain reactions of price changes stemming from a single trade or several trades which complete a "meaningful" chart pattern.

Thus, a transaction by an institution or any other investor which has no direct and immediate price effect, nevertheless can influence the decisions of other investors to buy or sell and thus change the price. But determining or measuring the institution's ultimate influence through such a chain of circumstances is impossible.

The nature of institutional impact

It may be ironic that some of the criticism aimed at institutions, especially by corporate officials, appears only when the purported effect was a price drop. The tendency to criticize has been less pronounced where an institution may have caused a rise.

Other critics have claimed that institutions, while not manipulating outright, have accomplished the same thing by the very size of their business. The "bandwagon effect", where the action of one or a few major investors influences the decisions of others who become aware of this action, is said to end in the same result as manipulation.

The Exchange has no knowledge of any questionable action by an institution—e.g., purchasing a stock in quiet and then, to push up the price, deliberately spreading the word around that the institution has taken a large position in the issue. Furthermore, controlling the "bandwagon effect" (even assuming this were desirable) is virtually impossible. The market, by its very nature, has always been full of such influences, large and small; this has always been a fundamental part of its daily life.

Continuing Research

The Research Department will continue its examination of the institutional investor, including block data, portfolio turnover rates, and estimates of holdings of NYSE listed stock. Periodic reviews of Stock Watch data, similar to the one made here, can also be considered for the future, perhaps once a year. However, such information may not be exactly comparable to that presented in this report because of certain changes scheduled for next year in the nature of Stock Watch reviews.

Appendix III

The Stock Market (NYSE) on June 4, 1968

NEWS BACKGROUND

On May 30, President Johnson announced that he would accept a $6 billion expenditure cut in the Federal budget in return for the 10% tax surcharge he had been urging on Congress. The prospect of fiscal policy coming to the rescue of monetary policy was encouraging to investors who had become concerned about the risks of a credit squeeze.

After the Memorial Day holiday, the market moved up on Friday, May 31. The enthusiasm carried through on Monday, June 3, as many traders and investors returned from a long weekend. The exuberant market action of these two days attracted additional buying interest on Tuesday morning, and the market rose from the opening of trading. As *The New York Times* put it next day:

"A volley of buy orders at the opening sent prices on the New York Stock Exchange higher and most stocks then increased their gains as the day progressed. . . .

"Market observers noted that there were no new economic developments to account for the bullish tone of the market yesterday. However, they pointed out that institutional investors as well as the public had accumulated sizable funds and were anxious to invest in both investment grade and glamour issues.

"Yesterday's upswing, they said, seemed to represent an attempt by the large and small investors to acquire positions in the market 'before it ran away with them.'

"These observers also said that the prospects of a tax increase and a reduction in Federal spending had also been enticing more investors into the market. Traders prefer high taxes over tighter money, the alternative method to prevent runaway inflation."

In its regular column "Abreast of the Market," *The Wall Street Journal* on June 5 noted:

"Brokers again cited traders' belief of an improved outlook for passage of the tax surcharge-spending cut bill, the big supply of funds seeking investment, and an 'inflationary psychology' as the factors that powered the advance."

Stock Prices.—The NYSE Composite Index on June 4 closed up 0.28 at a new all-time high of 56.47, while the Dow-Jones Industrial Average rose 11.25 points to 916.63—well below its record high in February 1966. The movement of individual common stocks was as follows:

Advances	686
Declines	405
Unchanged	139

The NYSE Index had had larger advances in recent days, for example:

June 3	0.69
May 31	.43
May 28	.34
May 21	.29

The Dow Industrials, however, experienced its sharpest gain in nearly two months.

The pattern of price movements during the day was as follows, with the changes measured against the previous day's close:

	NYSE index	DJIA		NYSE index	DJIA
10:30	+0.16	+4.21	1:30	+.23	+7.28
11:00	+.19	+4.57	2:00	+.28	+7.76
11:30	+.22	+5.13	2:30	+.29	+8.60
12:00	+.20	+5.59	3:00	+.28	+8.90
12:30	+.22	+6.25	3:30	+.28	+11.25
1:00	+.23	+7.64			

Share Volume.—Reported volume, at 18,037,000 shares, was the third largest in Exchange history. The total number of trades handled by the Market Data System was 62,050, and the average number of shares per trade was 291.

A month earlier, the Exchange had experienced a level of volume almost identical to the June 4 figure. The table below provides an extremely interesting comparison of the volume breakdown for the two days:

	June 4	May 3	Percent change
Reported share volume	18,037,000	17,989,000	+0.3
Total number of trades	62,050	57,822	+7.3
Shares per trade	291	311	−6.4
Trades at 100 and 200 shares	48,140	44,531	+8.1
Trades at 1,000 shares and over	2,895	3,046	−5.0

The distribution of round-lot share volume by price group on June 4 is compared below with a similar distribution for the month of May.

	Percent			Percent	
	June 4	May		June 4	May
Under $10	2.2	2.0	$40 and under $50	17.2	17.1
$10 and under $20	14.1	13.1	$50 and under $60	11.0	13.1
$20 and under $30	18.3	18.7	$60 and under $100	13.0	14.4
$30 and under $40	20.7	18.0	$100 and over	3.5	3.6

Thus, volume in low-priced issues was negligible—not much more than during the whole month of May.

Member activity.—Forms 121 showing member trading for June 4 will not become available until approximately June 14. The only data now available show the transactions of registered traders. They were as follows:

Purchases	71, 300
Sales (including 35,700 sold short)	127, 000
Net Sales Balance	55, 700

The registered traders accounted for 0.5% of twice total volume. In addition, 94.7% of their transactions were stabilizing.

Institutional activity.—One indication of institutional participation in the market is the number of large blocks (10,000 shares or more). The figures in the table below compare June 4 with May 3, the day of comparable overall volume.

	June 4	May 3
Number of blocks	55	49
Shares in blocks	1, 312, 800	1, 320, 600
Block volume as percent of reported volume	7. 3	7. 3

The Exchange has been developing, on an experimental basis, a panel of automated member organizations which provide monthly data on the sources of their volume. These firms were asked to supply—for June 4—the same kind of broad breakdowns of customer activity that they have been providing for several months. Overall, the firms able to supply the one-day data represent over 20% of NYSE 1967 net commissions, but they are not necessarily representative of all types of volume. For example, they may understate the importance of institutional activity.

Nevertheless, the net institutional share volume for the sample firms in aggregate on June 4—on a non-projectible basis—was as follows:

	Purchases (+) *Sales* (−)
Mutual funds	+19, 200
Banks	+55, 668
Nonmember broker/dealers	−14, 700
Other institutions	−46, 437
Total	+13, 731

Public individuals' activity.—The same special panel provides a breakdown of cash and margin activity of public individuals. Again, on a non-projectible net basis, the sample firms in aggregate showed the following share volume by public individuals on June 4:

	Purchases (+) *Sales* (−)
Cash accounts	−171, 019
Margin accounts	+14, 384
Total	−156, 635

Another set of relevant figures are the daily odd-lot transactions, indicative of what the so-called small investor did in the market. The June 4 share data below show the same pattern that has prevailed without exception every day from April 1 on.

Purchases	867, 571
Sales (including 5,891 sold short)	1, 052, 053
Net Sales	184, 482

Cleared volume breakdown.—In a further attempt to gain some insights into the sources of volume on June 4, Stock Clearing Corp. machine runs were examined. Runs were set up to show aggregate purchases and sales for all round-lot volume cleared through SCC for that date (96.6% of reported volume).

Firms were classified as to the percentage of their total volume in the October 1966 Public Transaction Study which originated from institutions and intermediaries or public individuals. Any firm which did 60% or more of its volume for accounts of institutions and intermediaries on the PTS day (amounting to at least 10,000 shares altogether), was considered an institutional house. All other firms were considered public retail houses. The results for June 4 follow:

	Purchases (+)	Sales (−)	Net
Institutional	3,762,960	3,495,150	+267,810
Public retail	13,658,080	13,925,890	−267,810

Incidentally, 25 of the 40 so-called institutional houses had net purchase balances.

Conclusion.—The bits and pieces of available evidence—while admittedly imperfect—permit some inferences to be drawn.

1. The upsurge in volume was apparently accounted for by public individuals. The number of trades on June 4 was 4,228 more than on May 3—a day of comparable volume; trades of 100 and 200 shares accounted for 3,609 of the increase, while trades of 1,000 shares and over declined by 151.

2. Public individuals, however, were primarily on the sell side—except for margin accounts.

3. The purchase side of the market was dominated by institutional investors—especially banks and mutual funds.

Mr. Moss. And without objection, the letters referred to, the letter from Mr. Haack to the subcommittee under date of March 12, 1968, will also be included following your statement, as will the letter of Chairman Cohen dated February 14, 1968.

In there objection?

Hearing none, it is so ordered.

(The documents referred to follow:)

New York Stock Exchange,
New York, N.Y., March 12, 1968.

Hon. John E. Moss,
Rayburn House Official Building,
Washington, D.C.

Dear Mr. Moss: The purpose of this letter is to convey to you and the other members of the Committee for your consideration the views of various organizations in the securities industry on a proposed study of institutional activity. These views are shared by the New York Stock Exchange, American Stock Exchange, Association of Stock Exchange Firms, Investment Bankers Association of America, Investment Company Institute and National Association of Securities Dealers.

We have had extensive conversations with the Securities and Exchange Commission and in particular with Chairman Cohen on the basic approach to the study, its scope, and organization. With Chairman Cohen's permission, I am attaching hereto his most recent letter which outlines the views of the Securities and Exchange Commission on the general purpose of the study, the specific questions to be investigated, the research organization to be assembled, the role of the Advisory Committee, and plans to encourage the publication of different viewpoints should they develop. Chairman Cohen's recommendations accord with our view of the project. What we both have in mind is a basic economic study not an investigation. Its purpose would be to analyze the economic process and future implications of rising institutional participation in the equity markets. The study would not be intended to produce or become the vehicle for disciplinary proceedings or other enforcement actions.

I should like to stress the active role to be played by the Advisory Committee which, I hope, would be a small, representative group, and therefore not hampered by unwieldy size. We would suggest also that the Commission seek the advice and counsel of the Advisory Committee in the selection of a Staff Director. By so doing, the Commission could hope to select the most capable person available with a broad background in the areas to be studied.

Hopefully, any resolution passed by the Congress will specify many of the thoughts outlined here and in Chairman Cohen's letter. It may also be desirable to make both a part of the legislative record.

Please let me know if I can clarify any of the suggestions offered here for consideration by the Committee on Interstate and Foreign Commerce or if I can be of service to you in any other way.

Sincerely,

ROBERT W. HAACK,
President.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., February 14, 1968.

Mr. ROBERT W. HAACK,
President, New York Stock Exchange,
New York, N.Y.

DEAR BOB: There seem to be a number of misconceptions concerning the study of the impact and role of institutions in the securities markets which Congressmen Moss and Keith have proposed and which the Commission supports. I thought it would be helpful to set down in some detail precisely what we do, and what we do not, have in mind.

First and foremost, I wish to make clear that this is to be an economic study, not an investigation. It is intended to produce information concerning basic economic trends that will be helpful to the Commission, to the self-regulatory agencies, to the industry, and to everyone else concerned with the role of institutions in the securities markets; it is not intended to produce disciplinary proceedings or other enforcement actions against any firms, persons or institutions. Nor would it be used to conduct investigations for any such purpose.

Among the questions to which the proposed study might direct its attention are the following: Has the growth of institutional investors encouraged the flow of equity financing? Or has it merely substituted institutional for individual investment? Will the supply of equity securities balance the increasing demand from institutional investors? Has the total volume of stock trading increased by more than what one might expect in the absence of large institutional investment? If so, has the increased trading tended to increase the liquidity of markets or has it had the opposite result? Is the increase in trading concentrated in certain types of institutions, or is it typical of all categories of institutional investors?

What impact on stock price trends should one expect from growing participation of institutional investors, given their longer-term investment horizons and the possibilities available to them of averaging risks? Has any such trend actually developed? What effect has it had on the investment objectives of individual investors? What changes are occurring in the relationships among individual investors, institutional investors, and the corporate issuers and their managements? These are representative of the important economic issues worthy of study.

Most prior studies made by the Commission pursuant to Congressional direction were initiated because Congress was concerned about the possibility that serious malpractices existed in some area or that existing regulatory controls were inadequate. Such studies, therefore, necessarily focused upon determining the extent and nature of improper practices which might exist and upon determining whether or not regulatory objectives were being evaded or controls were otherwise ineffective. The purpose of the present study, by contrast, will be to obtain more information about, and better understanding of, an economic phenomenon—"institutional investing"—and to determine its impact upon individual investors, the corporate issuers, the securities firms, and the public capital markets.

Institutionalization of investment is probably the most significant phenomenon in the securities markets today. It is a dramatic and developing process, concerning which all of us should be informed as promptly, as currently, and as continuously as possible. There is little doubt as to the need for such study or the potential dangers if one is not undertaken promptly.

A question has, however, been raised whether the Commission is the appropriate body to undertake this study. In my view, the Commission is the logical organization to shoulder this responsibility, and possibly the only one that can meet all of the necessary criteria.

First, the Commission is the agency established by the Congress specifically for the purpose of conducting studies of this nature. We already have a statutory obligation to keep abreast of developments in the securities markets and to report our conclusions to the Congress whenever we become aware of matters which should be brought to its attention, whether or not legislation is proposed.

Second, the study necessarily must go beyond the mere collection of statistics and similar data. We have authority to obtain, and experience in obtaining, data concerning existing and developing practices of the different, and frequently competing, institutions, as well as information concerning the nature and dimensions of any problems which flow from them. The Commission can also assure, when and to the extent appropriate, confidential treatment of information furnished for the purposes of the study.

Third, in order to assure the usefulness and effectiveness of the study, it should be under the direction of any agency which has not merely an academic interest in the operation of the securities markets, but a long-term responsibility for the health, and well-being of those markets. An *ad hoc* committee composed of representatives of the various interested groups and put together solely for the purpose of conducting a single study would not have this long-term responsibility, and would also have much more difficulty in developing the cohesion and centralized direction necessary to the successful conduct of the study.

Fourth, the study might develop information and raise questions of significance under the anti-trust laws, with which only the Commission would be in a position to deal effectively.

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 groups, and distinguished economists to consider the nature and dimensions of the study, the types of information most urgently needed, and the most effective ways of obtaining and analyzing that information. It is essential that the Commission have the benefit of the thinking of a group of this nature, not only in planning this study, but in advising the Commission on a continuing basis of new developments which should be taken into account in the Commission's work. I contemplate that this group would join us in the creation of an 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 that it would have an active role in shaping the scope and conduct of the study. This would mean that, as information is gathered, it would be made available promptly to the advisory committee so that they will be in a position to offer informed judgments to the Commission.

To staff the study group, which would operate outside the regular framework of the Commission organization, but remain subject to continuing and close Commission oversight, I contemplate that we would recruit outstanding people from industry, from universities, and from other agencies of the government. The Commission would welcome suggestions and the assistance of all industry groups in recruiting the best persons available. We would also assign to the study members of the Commission's staff who have a special familiarity with the technical operation of, and current trends in, the various securities markets, or who are now and have been working on economic issues to be considered in the study. Certain of the issues to be explored could be made the object of studies by distinguished economists not employed directly by the study staff. Every effort would be made to seek out persons of such stature and independence as to insure the objectivity of viewpoint and result of the study. In any event, arrangements would be made so that those in charge of the study would have direct and immediate access to the Commission, the Advisory Committee and leading economists in the nation.

I anticipate that when the study staff has developed its tentative report, it would be made available to the Advisory Committee and to the Commission. I would hope that the Commission and thhe Advisory Committee would agree on all points. Should some differences develop, however, the committee or any member of it would have full opportunity, and such assistance as the study staff can provide, to spell out (in the final report) any differences and the reasons therefor.

As you know, we have submitted to Chairman Moss, at his request, a proposed budget, for use in connection with further action on the resolution which he and Mr. Keith introduced in the last session of the Congress. That budget was prepared on the assumption that the Commission would be required to do all of the work involved in gathering and analyzing the necessary information. To the extent that portions of the work would be done by outside economists under special arrangements, the budget would be revised. To the extent that self-regulatory agencies, industry groups and others may be able to assist the Commission in the gathering or processing of this information—and I want to make clear again that we welcome, and indeed solicit, such assistance and cooperation—the demands on the Commission's time and manpower, and correspondingly upon the appropriation required, would of course be reduced.

I hope that the foregoing will put to rest any concern that may have arisen regarding the purpose and scope of the proposed study. If any further information would be useful, please let me know.

Sincerely,

MANUEL F. COHEN,
Chairman.

Mr. MOSS. Mr. Keith, do you have any questions?

Mr. KEITH. Yes; I have one or two, perhaps not directly pertinent. How many vice presidents does the stock exchange have?

Mr. CALVIN. I believe eight.

Mr. KEITH. What is your particular responsibility?

Mr. CALVIN. My responsibility is civic, government, and legal affairs.

Mr. KEITH. Well, welcome to Washington.

Mr. CALVIN. Thank you.

Mr. KEITH. Do they have a vice president in charge of institutional trading?

Mr. CALVIN. No. We do have an institutional investors department.

Mr. Keith, we have an annual report which I have sent you a copy of, and more recently a factbook which I sent to you which outlines our organization.

Mr. KEITH. I have found it very interesting. Terms with which I was not familiar were nicely explained.

Mr. CALVIN. Very good.

Mr. KEITH. Has the institutional trading accelerated the amount of volume discounts? If that continues the way it is, it will offer some interesting problems so far as services rendered and fees paid in connection therewith.

What percentage of your income comes from institutional trading versus individual trading?

Mr. CALVIN. I will ask our director of research, Stan West, to talk on that, if I may.

Mr. WEST. Mr. Keith, I cannot tell you exactly at the present time what that percentage might be, but on the basis of studies done in 1966 which indicated the percentage of our volume coming from different sources we assume that the Commission breakdown is the same as the volume breakdown.

Institutions at that time accounted for about one-third of our share volume. NYSE members, themselves, accounted for about a fourth and public individuals were between 40 and 45 percent.

Mr. KEITH. Do you think it is fair to let the record indicate that the actual return is comparable to the volume, institutional versus individual?

Do you see the point I am trying to make here?

Mr. CALVIN. I think what you asked was the percent of return. What he is answering is the percentage of volume.

Mr. KEITH. He prefaced his statement assuming that the income reflects proportion to the volume. He would assume it would be thus and so. That is exactly what I am looking for, whether or not there is economy of size.

Is that impact felt in your exchange?

Mr. CALVIN. May I answer by saying it this way: I don't think there is evidence of disagreement between the Securities and Exchange Commission and the New York Stock Exchange as to the need for a volume discount. I think everyone has agreed that there are economies of size.

To refresh your memory, I am sure you recall that back in January the New York Stock Exchange proposed to the Securities and Exchange Commission that there be a volume discount. More recently, the Commission has directed a request to the New York Stock Exchange that a proposed volume discount be put into effect, and that is being considered now. So that, really, there is no disagreement here.

Mr. KEITH. There is disagreement as to when it should be effected?

Mr. CALVIN. There is no disagreement as to the need and as to the advisability for a volume discount based upon economies of size. There has been no agreement thus far as to how that will be structured and as to the level of that discount.

The Securities and Exchange Commission has come forward with a proposal that deals with both structure and level.

Mr. KEITH. The point I am trying to make here is that if you concentrate buyers in the wholesale field, it further accelerates the tendency toward institutional buying because the costs will be less involving institutions than involving individuals and it will be an accelerating factor.

Mr. CALVIN. That certainly is a matter that everyone has considered and is something that makes a complicated problem a little bit more complicated.

Mr. KEITH. No further questions, Mr. Chairman.

Mr. MOSS. Gentlemen, I want to thank you also for your appearance and for your support of the resolution.

There are no further questions.

Mr. CALVIN. Thank you, Mr. Chairman.

Mr. MOSS. Our next witness is Raymond W. Cocchi, president of the Independent Broker Dealers' Trade Association.

STATEMENT OF RAYMOND W. COCCHI, PRESIDENT, INDEPENDENT BROKER DEALERS' TRADE ASSOCIATION; ACCOMPANIED BY JAMES BUTTERFIELD, TREASURER

Mr. COCCHI. Mr. Chairman, my name is Raymond W. Cocchi. I am the president of the Independent Broker Dealers' Trade Association. With me today is James Butterfield, the treasurer of our association.

We wish to thank you, Mr. Chairman, for allowing us to appear here today and, with your permission, I will submit our statement for the record and summarize very briefly.

Mr. MOSS. Without objection, the statement is received in its entirety for the record at this point.

You may proceed with your summary.

(Mr. Cocchi's prepared statement follows:)

STATEMENT OF RAYMOND W. COCCHI, PRESIDENT, INDEPENDENT BROKER-DEALERS' TRADE ASSOCIATION

My name is Raymond W. Cocchi and I appear here as president of the Independent Broker-Dealers' Trade Association, an industry group made up of securities dealers who are not members of the New York Stock Exchange. Although some of our members are also members of national securities exchanges other than the New York Stock Exchange, we try to speak for the more than 3,000 securities dealers in the United States who are members of the National Association of Securities Dealers but who are not members of the New York Stock Exchange. Our members are largely local and regional dealers, ranging from small broker-dealers to fairly large organizations. Often we are virtually the only means of raising new capital available to local industry and may offer the only available access to the securities marketplace for investors in a firm's particular geographical area. We are interested in any and all proposals affecting the securities industry.

As we understand H.R. 7696, it would amend Section 7 of the Securities Exchange Act of 1934 to authorize the Federal Reserve Board to extend margin regulation to over-the-counter securities. The 1934 Act at present restricts broker-dealers from extending credit to purchase or carry securities traded in the over-the-counter market but allows banks to lend on such securities without restriction. H.R. 7696 would put over-the-counter securities on the same basis as securities listed on national securities exchanges for margin purposes, that is, it would permit broker-dealers to extend credit on over-the-counter securities subject to Federal Reserve Board rules and regulations. In addition, it would permit the Federal Reserve Board to restrict the extension of credit for the purpose of over-the-counter securities in amounts greater than the applicable margin rates as the Board now does as to listed securities only. The existing distinction in treatment afforded by the Securities Exchange Act of 1934 as between listed stock and over-the-counter stock was based on a presumed lack of liquidity for over-the-counter issues and a lack of current financial and price information. The situation has changed substantially since 1934 and under existing law over-the-counter securities are subject to as complete disclosure as listed securities in most cases, and a reliable quotations structure has developed within the industry. By permitting brokers and dealers to extend credit on OTC securities, H.R. 7696 would eliminate the existing inequity which allows banks, but not securities brokers and dealers, to extend credit on over-the-counter securities. We believe this legislation will be in the public interest and will increase investor protection.

Respecting H.J. Res. 946, to authorize the SEC to make a study of the impact of institutional investors on the securities markets, we understand it would result in an economic study and not an investigation. We particularly favor SEC Chairman Cohen's proposal to establish an ad hoc committee composed of representatives of the various interested groups in the industry, organized for the purpose of working with the SEC staff in the study. We are in favor of a study of the kind envisaged in the exchange of correspondence between Robert W. Haack, President, of the New York Stock Exchange, and Manuel F. Cohen, Chairman, of the Securities and Exchange Commission. We would strongly urge that a representative of our organization be included among the members of the ad hov Advisory Committee.

Mr. COCCHI. Thank you.

The views of the Independent Broker Dealers' Trade Association generally parallel the views of those that have already testified here today.

We feel that we have nothing further to offer other than to say that we do agree on both H.R. 7696 and House Joint Resolution 946 and do hope that the Securities and Exchange Commission will see fit to include one of our members on the advisory committee.

We stand ready, Mr. Chairman, to also offer you any information that you may request of us.

Thank you.

Mr. Moss. Thank you, Mr. Cocchi.

Certainly the subcommittee will feel free to call upon you for any information that we might require, and I want to express my appreciation for the support that you offer on behalf of the members of your association.

Mr. Keith, do you have any questions?

Mr. Keith. I have just one question, Mr. Cocchi.

Would you for the record make some observations as to what you think your association might contribute to this study group?

Mr. Cocchi. Yes. Something that you directed some questions to earlier this morning. You got into the area of your belief that the over-the-counter trades might be easier to extract information from than those listed on the national exchanges.

Amongst our group, Mr. Keith, are wholesalers, market makers of over-the-counter securities who do in fact accept and execute orders for various institutions. These members of ours act in the same capacity as the specialists on the New York Stock Exchange.

I am sure that we would be able to extract some helpful information with respect to those of our members that act as specialists in over-the-counter securities.

Mr. Keith. Any others?

Mr. Cocchi. Well, you are catching me off guard. I have Mr. Thomas Conrad standing by who is a person that, if we are allowed to place a man on this advisory committee, I have already selected to appear. He has been working on this for some time. I am sure he would be able to offer more information than I am offering you today.

Mr. Keith. Is Mr. Conrad here?

Mr. Cocchi. Mr. Conrad was unable to appear today, Mr. Keith.

Mr. Keith. If you would, have Mr. Conrad write us as soon as possible.

Mr. Cocchi. Yes, sir; I will be happy to have him express to you what contribution we might be able to make to this advisory committee.

Mr. Keith. Thank you.

Mr. Moss. We will hold the record open to receive that.

Would you have that material supplied just as promptly as possible? It is of the utmost importance that we move hurriedly on this.

Mr. Cocchi. I will.

(The information requested was not available at time of printing.)

Mr. Moss. I want to thank you gentlemen, also.

You are excused.

Mr. Cocchi. Thank you.

Mr. Moss. There being no further witnesses, the committee stands adjourned.

(The following material was submitted for the record:)

Association of Stock Exchange Firms,
New York, N.Y., June 20, 1968.

Hon. John E. Moss,
Chairman, Subcommittee on Commerce and Finance,
Rayburn House Office Building,
Washington, D.C.

Dear Mr. Moss: This letter is submitted in support of H.R. 7696, the over-the-counter margin bill, and H.J. Res. 946, the institutional study proposal, which are to be the subjects of public hearings before your subcommittee on Friday, June 21, 1968.

We endorse, as being in the public interest, the principles underlying both bills: H.R. 7696, because it would round out the protections and advantages afforded by margin regulation; H.J. Res. 946, because the understanding to be derived from an economic study of this character would assist regulatory and self-regulatory agencies, the securities industry and institutions themselves in developing the rules, structures and resources necessary to meet the public's needs. Further, we concur in the points in support of such measures which we understand will be made in the statements of the New York Stock Exchange at the public hearings.

In this letter we wish to address ourselves particularly to one question which has arisen with respect to H.R. 7696; whether broker-dealers should be allowed to extend margin on stocks in which they are also making markets. In our judgment, the regulation to be written by the Federal Reserve Board pursuant to the authorization of H.R. 7696 should permit broker-dealers to act in the dual capacity of lenders and market-makers. This judgment is predicated on the belief that if firms are forced to choose between these two activities, they would be compelled to withdraw from market-making in over-the-counter stocks. In our view, this would result in a number of serious, adverse consequences:

(1) It would remove up to 50% or more of the total capital now being employed in making markets in such stocks and thereby injure the liquidity, continuity and depth of such markets.

(2) The competition provided by these firms, which is essential to making the best markets, would similarly be removed, and market-making would be left in the hands of a relatively few wholesalers.

(3) Given these events, the spread between prices would widen and markets could become highly volatile, increasing rather than decreasing the potential risks of manipulation and conflict of interest.

New York Stock Exchange studies indicate that in the market for listed stocks, margin activity represents only 18% of total share volume. If similar ratios prevail for over-the-counter stocks, then the over-all effect of removing these market-makers would work to the detriment of cash customers as well. Moreover, these adverse consequences would fall only on the best quality stocks, that is, those selected as marginable by the Federal Reserve Board.

We believe that the potential for conflicts of interest in situations where firms are both lenders and market makers is more theoretical than real. The over-the-counter stocks selected by the Federal Reserve Board will be required to meet high standards with respect to such matters as number of shares outstanding, number of shareholders and distribution of holdings, and trading volume. A firm making a market in one of these stocks would, irrespective of the number of other market-makers, be incapable of manipulating the market price because of the breadth of the market for such stock. In any event, in those few isolated instances where manipulation or conflicts of interest might occur, the SEC already has ample power to deal with them under the anti-fraud provisions of the Securities Exchange Act of 1934.

We appreciate the opportunity to present for the record our views on these bills and would be pleased to further assist the subcommittee in any way we can.

Very truly yours,

LEON T. KENDALL,
President.

J. M. LUMMIS & CO., INC.,
New York, N.Y., June 18, 1968.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce, Rayburn House Office Building, Washington, D.C.

DEAR MR. STAGGERS: This letter is written in response to your notice of June 14, 1968, making known the Public Hearing on H.R. 7696. It is our opinion that this proposed amendment to the Securities Exchange Act of 1934 should not be enacted.

It is our contention that there is not an excessive use of credit in the over-the-counter securities market and thus the raison d'etre of H.R. 7696 is lacking. One very apparent reason for this lack of excess is the heterogeneous manner in which credit is obtained on loans secured by over-the-counter securities; i.e., each borrower must arrange his own financing. It is felt that the enactment of H.R. 7696 would, in fact, increase rather than decreese the amount of credit in the over-the-counter securities market due to the greater ease by which such credit could then be obtained.

We witnessed an incerase of $190,000,000 in margin account debits in April of this year. That there was a substantial increase should not be surprising when the following factors are considered: 1) Subsequent to March 11, 1968, many outstanding loans at commercial banks were transferred to margin accounts at stock exchange firms. 2) As a result of the amendments to Regulation T many persons who had never borrowed against convertible bonds before were enticed into buying convertible bonds on margin.

The use of credit for the purpose of purchasing securities has been the "whipping boy" of those critical of speculation. The fact that the market in listed securities is still turbulent notwithstanding the June 7, 1968 increase in margin requirements suggests that there are elements other than the use of credit to be considered.

We witnessed a disorderly market subsequent to October 20, 1967, when the Federal Reserve originally made known their proposed amendments to Regulations U & T. That there was a disorderly market points out the deleterious result of sudden and severe change. Even now, some eight months after the original proposal and some three months after the enactment of the revised proposal, certain elements in the market are still going through a metamorphosis.

For the above noted reasons, we feel that H.R. 7696 not only lacks purpose, but also, if enacted, could prove to be antithetical to its intent.

Very truly yours,

John M. Lummis, Jr.

American Life Convention,
Chicago, Ill.
Life Insurance Association of America,
New York, N.Y., June 19, 1968.

Re House Joint Resolution 946.

Hon. John E. Moss,
Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

Dear Mr. Chairman: This is to advise you of the views of the American Life Convention and the Life Insurance Association of America in regard to the Joint Resolution now being considered to amend the Securities Exchange Act of 1934 to authorize an investigation of the effect on the securities markets of the operation of institutional investors. Our two associations have an aggregate membership of 353 life insurance companies in the United States and Canada. Their business in force is approximately 92% of the legal reserve life insurance business in force in the United States.

We have read House Joint Resolution 946 introduced by you and Congressman Hastings Keith on December 4, 1967, as well as the letters of Chairman Cohen of the Securities and Exchange Commission dated February 14, 1968, and of the President of the New York Stock Exchange dated March 12, 1968. We believe that the study of the market impact of the purchase, sale and holdings of securities by institutional investors would constitue an appropriate and constructive inquiry. We particularly welcome the emphasis on the economic aspects of institutional investments, since we think an objective analysis of the significance to the country of our capital markets would be most helpful. You may be sure that our two associations will cooperate fully in such a study.

Sincerely,

American Life Convention,
William B. Harman, Jr.,
General Counsel.
Life Insurance Association of America,
Kenneth L. Kimble,
Vice President and General Counsel.

(Whereupon, at 11:20 a.m., the subcommittee adjourned.)

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