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HEARING  
BEFORE THE  
COMMITTEE ON BANKING AND CURRENCY  
UNITED STATES SENATE  
NINETIETH CONGRESS

SECOND SESSION

ON

S. 1299 and S.J. Res. 160

BILLS 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 AND TO AUTHORIZE THE SECURITIES AND EXCHANGE COMMISSION TO MAKE A STUDY OF THE IMPACT OF INSTITUTIONAL INVESTORS ON THE SECURITIES MARKET

\_\_\_\_\_  
MAY 16, 1968  
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Printed for the use of the  
Committee on Banking and Currency



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KANSAS STATE UNIVERSITY LIBRARIES

SECURITIES EXCHANGE ACT AMENDMENTS

HEARING

BEFORE THE

COMMITTEE ON BANKING AND CURRENCY

UNITED STATES SENATE

NINETY-THIRD CONGRESS

COMMITTEE ON BANKING AND CURRENCY

JOHN SPARKMAN, Alabama, *Chairman*

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(II)

MAY 19 1962

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## SECURITIES EXCHANGE ACT AMENDMENTS

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THURSDAY, MAY 16, 1968

U.S. SENATE,  
COMMITTEE ON BANKING AND CURRENCY,  
*Washington, D.C.*

The committee met, pursuant to call, at 10:17 a.m., in room 5302, New Senate Office Building, Senator John Sparkman, chairman of the committee, presiding.

Present: Senators Sparkman and Bennett.

The CHAIRMAN. Let the committee come to order, please.

Today we begin hearings on Senate Joint Resolution 160, which would authorize the Securities and Exchange Commission to make a study of institutional investors and the effect of their transactions on our securities markets. The committee will also consider S. 1299, a bill to permit the Federal Reserve Board to regulate the amount of credit extended on unlisted securities.

(The bills and agency reports follow:)

(1)

**S. 1299**

---

**IN THE SENATE OF THE UNITED STATES**

MARCH 15, 1967

Mr. SPARKMAN (by request) introduced the following bill; which was read twice and referred to the Committee on Banking and Currency

---

**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.

1       *Be it enacted by the Senate and House of Representa-*  
2 *tives of the United States of America in Congress assembled,*  
3 That section 7 of the Securities Exchange Act of 1934 (15  
4 U.S.C. 78g) is amended—

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

7           (2) by modifying subsection (c) to read as follows:

8       “(c) It shall be unlawful for any member of a national  
9 securities exchange or any broker or dealer, directly or in-

1 directly to extend or maintain credit or arrange for the exten-  
2 sion of maintenance of credit to or for any customer—

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

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

21 (3) by striking “registered on a national securities  
22 exchange” in the first sentence of subsection (d) and  
23 “registered on national securities exchanges” in the sec-  
24 ond sentence of that subsection.

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

Hon. JOHN SPARKMAN,  
Chairman, Committee on Banking and Currency,  
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Reference is made to your request for the views of this Department on S. 1299, 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 "nonpurpose" 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 percent of the purchase price, but if he wishes to purchase 100 shares of an OTC issue he can borrow 60 percent, 70 percent 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 S. 1299, 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.*

90TH CONGRESS  
2D SESSION

# S. J. RES. 160

IN THE SENATE OF THE UNITED STATES

APRIL 18 (legislative day, APRIL 17), 1968

Mr. SPARKMAN introduced the following joint resolution; which was read twice and referred to the Committee on Banking and Currency

## 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

1        *Resolved by the Senate and House of Representatives*  
2        *of the United States of America in Congress assembled,*

II

1 That section 19 of the Securities Exchange Act of 1934 is  
2 amended by adding at the end thereof the following:

3       “(e) The Commission is authorized and directed to  
4 make a study and investigation of the purchase, sale, and  
5 holding of securities by institutional investors of all types  
6 including, but not limited to, banks, insurance companies,  
7 mutual funds, employee pension and welfare funds, founda-  
8 tion and college endowments, in order to determine the  
9 effect of such purchases, a sales and holdings upon the  
10 maintenance of fair and orderly securities markets and upon  
11 the stability of such markets, both in general and for indi-  
12 vidual securities, and upon the interests of the issuers of such  
13 securities and upon the interests of the public so that the  
14 Congress may determine what measures, if any, may be  
15 necessary and appropriate in the public interest and for  
16 the protection of investors. The Commission shall report to  
17 the Congress on or before December 31, 1969, the results  
18 of its study and investigation, together with its recommenda-  
19 tions, including such recommendations for legislation as it  
20 deems advisable. For the purposes of the study and investi-  
21 gation authorized by this subsection the Commission shall  
22 have all the power and authority which it would have if such  
23 investigation were being conducted pursuant to section 21  
24 of this Act. The Commission is authorized to appoint, with-  
25 out regard to the provisions of title 5, United States Code,

1 governing appointments in the competitive service, and to  
2 pay, without regard to the provision of chapter 51 and sub-  
3 chapter III of chapter 53 of such title relating to classifica-  
4 tion and General Schedule pay rates, such personnel as the  
5 Commission deems advisable to carry out the study and in-  
6 vestigation authorized by this subsection, but no such rate  
7 shall exceed the per annum rate in effect for a GS-18. To  
8 carry out such study and investigation there is hereby au-  
9 thorized to be appropriated the sum of \$825,000.

10 "In connection with such study, the Commission shall  
11 consult with representatives of various classes of institutional  
12 investors, members of the securities industry, representatives  
13 of other government agencies, and other interested persons,  
14 and with an advisory committee which shall be established  
15 by the Commission for the purpose of advising and consult-  
16 ing with the Commission on a regular basis on such matters."

(7)

The CHAIRMAN. Under current law unlisted securities are exempt from the Federal Reserve Board's margin requirements, and stockbrokers are prohibited from extending credit on their purchase. Banks are, however, free to extend as much credit as they wish in this area as long as it is consistent with prudent banking practices.

Originally, this decision—reached in 1934 under the Securities Exchange Act—was based on the lack of available information concerning unlisted stocks. At that date the Congress felt that banks with their long-standing experience in extending credit were far better suited for this function than broker-dealers.

However, over the past three decades the securities acts have been amended so that the information available on unlisted securities is almost identical to that available on those listed on national securities exchanges. Both the Federal Reserve Board and the Securities and Exchange Commission agree that past distinctions concerning the extension of credit no longer apply. Accordingly, they have recommended that where there is an adequate market and all necessary facts are available, stockbrokers should be permitted to extend credit under Federal Reserve Board supervision.

S.J. Res. 160 would authorize the Securities and Exchange Commission in cooperation with an industry advisory committee to make a study of the effect of institutional investors on our Nation's securities markets.

Over the last 10 years, the equity holdings of financial institutions have more than doubled. In the past year alone, the assets of private noninsured pension funds have increased by \$7.4 billion to a total of \$72 billion. Similar growth by other financial institutions raises many questions concerning the impact and effect of their stock transactions on our securities markets.

Problems concerning price fluctuations and the effect on market liquidity caused by the sale or purchase of large blocks of stock in a single company remain unresolved. There is also great concern over potential conflicts of interest between the institutional investor holding large blocks of a company's stock and company management. In addition, there is a need for more information on short-term trading and the market impact of rapid portfolio turnover.

For example, in 1967 the combined value of stock transactions by pension funds, mutual funds, and insurance companies exceeded \$47 billion, an increase of 46 percent over 1966. Mutual funds in particular during the last 2 years have increased their portfolio turnover rate from 21 percent to 39 percent. Such activities may well be detrimental to the orderly operations of the securities markets.

Presently, however, there is a lack of reliable and comprehensive data concerning institutional investors upon which sound judgments and decisions can be made. Only by a thorough and far-reaching study such as proposed in this resolution can all the facts be ascertained. The cooperative efforts of both industry and government are essential in this area. And I am confident that this study will provide us with a factual framework for future action which will strengthen and bring continued public confidence to our Nation's securities markets.

Senator Bennett, do you have a statement?

Senator BENNETT. I would just like to make the observation that I certainly favor the study. I think it is perhaps a little overdue. But I hope when the study is made that those charged with it will be

concerned also with the economic impact upon the whole economy of the Nation and upon our economic processes, as well as concern about the effect on the machinery and the pattern of operation of the securities market.

I think this can have some very serious general economic implications, and I hope these will be made a part of the study.

Every once in a while I run into situations where a study is set up, and then something that might be unpleasant is left out or ignored. I don't know whether this will be unpleasant. But since we're charged with, for instance, the value of the currency, which is a basic economic problem—and I'm not saying that is involved in this—I hope the basic economic impact and factors will be an important part of this study.

And I am saying this in order to get myself and I hope the committee on the record.

The CHAIRMAN. I fully agree with your statement. In fact some of the areas which are to be covered—may bring up problems which we may wish were not in existence——

Senator BENNETT. That's right.

The CHAIRMAN. But we must not ignore them.

And if I can be just a little more explicit, I want to say this: There have been occurrences over the last year or two that have made quite an impression on my thinking in this field. One was the speech delivered by the Chairman of the Federal Reserve Board some time ago about the impact on the stock market of institutional investing.

I have also noted over the last year or two the prominent part played by mutual funds in corporate proxy fights. I hope that the study will certainly look into this area. I think that the study should not overlook the question as to whether or not the good of mutual fund shareholders has been disregarded by mutual funds when they enter a proxy fight for the purpose of sustaining or overthrowing the management of a particular company.

I do not believe that, as important a part as mutual funds play in our economic life and with their many thousands of shareholders, a great number of whom are small investors, that there should be this type of activity.

Senator BENNETT. I am concerned about that too. I am concerned with the maintenance of the availability of mutual fund type of investment to the small investor, but I agree with you, once those funds have been gathered together to create more power than the small investor would have, I don't think they should be manipulated either for or against the management of a particular company, disregarding shareholder interest and welfare.

The CHAIRMAN. Now, I presume all of our witnesses know the situation with which we are confronted. The Senate went into session at 9 o'clock. We have already started voting, and we are going to have to vote again rather shortly. I understand that all of those who were to appear in person are willing to submit papers for our consideration and have agreed to answer questions which will be submitted to them in writing or which may be suggested by their papers. Or any other questions that committee members may wish to ask.

Am I correct in that statement?

Is there any objection to that which I have stated?

Mr. COHEN. No, sir.

Mr. ROBERTSON. Not from the point of view of the Federal Reserve.  
The CHAIRMAN. Not on the part of Governor Robertson representing the Federal Reserve.

Not on the part of Chairman Cohen representing the Securities and Exchange Commission.

Is Mr. Haack here?

Mr. HAACK. We are perfectly agreeable to that.

The CHAIRMAN. You are agreeable to that? How about Mr. Walbert?

Mr. WALBERT. Yes, sir. We are in agreement.

The CHAIRMAN. And Mr. James W. Walker, Jr.?

Mr. WALKER. We are agreeable.

The CHAIRMAN. And Mr. Robert L. Augenblick?

Mr. AUGENBLICK. We are in agreement.

The CHAIRMAN. And Mr. Leon P. Kendall?

Mr. KENDALL. Yes, sir; we are in agreement.

The CHAIRMAN. Well, gentlemen, we certainly appreciate it. You have caught us in a tight place. We apologize for having you down here on an occasion such as this, but there are situations which we cannot always prevent.

Mr. COHEN. Mr. Chairman, may I just—

The CHAIRMAN. Mr. Cohen.

Mr. COHEN. May I speak to the point that Senator Bennett made and you made? I will take about 2 minutes—

The CHAIRMAN. Yes. All right.

Mr. COHEN (continuing). Which as you know from past experience is probably unlikely, but I promise.

The points Senator Bennett made are very good points—that is, the effect of the institutional growth on the economy as a whole, and vice versa. We are very much aware of this problem.

A study which would encompass all aspects of the capital markets, including the money markets, the bond markets, as well as the equity markets, is a very substantial study. But, recognizing the interrelationship of all of these matters, I have had a number of discussions with various people who are interested in this matter, and yesterday I went to New York specifically to meet with a group that is interested in dealing with aspects of this growing institutionalization, which perhaps would not be within the immediate scope of the study. Our study is pitched toward the equity markets and the relationship of the institutional investor to it.

I think it is fair to say, Senator, that, one, we will give effect to these considerations, but I believe, based on my discussions in the meeting I had yesterday, that other scholars, other foundations and study groups will be engaged in other areas such as the mortgage market, the bond market, and the money market.

I think that there is a general awareness in the country and in the profession, economic profession, as well as in industry that these things should go forward. I just wanted to assure you that there is consideration being given to it.

Senator BENNETT. Well, your study and the report that comes out of it might suggest to the committee the need for additional studies, and I would think that would be a useful result.

Mr. COHEN. As a matter of fact, if I heard any criticism yesterday from these gentlemen, who are experienced in these fields, it is that

we are being too modest in our request for funds. They told me I had misplaced a decimal point in terms of needed funds and resources. But we are not asking for any more money than we originally requested.

Now, the second point I wish to speak to is the point made by Senator Sparkman. It is contemplated by all of us that the study would move into these areas so that our fund of information and understanding of what is going on would be enhanced, at the end of which time there may be recommendations or suggestions either for further study or for some appropriate action.

The CHAIRMAN. Thank you very much. And thank you, gentlemen. (Whereupon, at 10:30 a.m., the committee adjourned, subject to the call of the chairman.)

(Prepared statements of the witnesses and additional data follow:)

**STATEMENT OF MANUEL F. COHEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION ON S. 1299**

Mr. COHEN. 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 S. 1299 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 Senate bill 1299. 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 Acts 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 market-makers 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 economy. 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 percent of the value of the securities pledged. In light of the important role performed by bona fide market-makers 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.

#### **STATEMENT OF MANUEL F. COHEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION ON SENATE JOINT RESOLUTION 160**

Mr. COHEN. Senate Joint Resolution 160 will make it possible for us to respond to an important and increasingly recognized need. This need is for more information and understanding with respect to the participation by institutions 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 which will provide an illustration of this growth. These statistics are admittedly incomplete, since for certain types of institutions, adequate statistics

simply are not available. That fact, incidentally, is a further illustration of the need for the proposed study.

During the last decade, as you can see from table 1 (p. 17), the total value of stock outstanding held by a selected group of institutions rose from \$29½ billion to \$13½ billion. The share of total stock outstanding held by these institutions rose from 10.3 percent to 18.6 percent. 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.

These figures do not cover personal trust funds, common trust funds, foundations, and college endowment funds. Useful statistics are not available on even a yearly basis for these institutions; we estimate that at the end of 1967 they held almost \$100 billion of stock, or 14.2 percent of total stock outstanding at that time. In other words, the total institutional stockholdings amounted to \$230 billion, or about one-third of total stock outstanding at the end of 1967. This compares with \$65 billion, or 23 percent, of outstanding stock a decade ago.

However, the statistics we do have are sufficient to portray the sharp growth not only of institutional shareholdings but also of the participation of institutions in the 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 10 years ago. On the average, investment companies turned over almost 40 percent of their stock portfolios in 1967 compared with a 14-percent rate a decade ago. The turnover rate of private noninsured pension funds rose from less than 4 percent in 1957 to over 11 percent last year; and these are averages. Individual institutions range considerably in the rate 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 percent. 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 upon the functioning of securities markets, the raising of capital by American business, upon the interests of individual investors, who also use the securities markets, and upon the companies in whose stock these institutions invest. It is also an important economic phenomenon, and analysis and study with respect to it by competent economists, which is an important part of the proposed study, should contribute significantly toward our understanding of the workings of the economy.

Concern with the role of institutional investors in the stock markets is, of course, not new, nor has it been confined to the Commission. As long ago as 1955, this committee instructed its staff to coordinate a study of the participation by institutional investors in the stock markets. 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 but that institutional trading primarily reflected shifts in the evaluation of

business prospects. A few years later, in the early 1960's, the SEC "Special Study of the Securities Markets" devoted a portion of its efforts to institutional trading in greater detail than the earlier study and raised many more specific questions with respect to the way 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 this committee was a pioneering effort to obtain some data on the amount of institutional activity in particular stocks, and our "Special Study of the 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 devoted 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 other institutional investors and that, although considerable data with respect to 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 with respect to 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." This aspect of our report aroused considerable interest among Members of Congress who are considering our proposed mutual-fund legislation and it is undoubtedly a factor leading to the introduction of Senate Joint Resolution 160 and its companion joint resolution of the House of Representatives, which was introduced last December by Congressman Moss and Congressman Keith.

The available data with respect to the activities of various types of institutions in the stock markets range from fairly extensive information as to registered investment companies, collected not only by the Commission but by the Investment Company Institute, to almost no information at all with respect to 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 life insurance companies. With respect to pension funds, our staff collects a certain amount of statistical data on a voluntary basis, and with respect to insurance companies, the Institute of Life Insurance collects certain monthly data from companies accounting for 93 percent of total assets. As to none of these, however, do we have data on individual transactions or holdings in individual stocks. As to insurance companies, this information exists in the reports which they file with State regulatory authorities having jurisdiction over them, but these data are not assembled or published.

Obviously, the first task of the proposed study would be to remedy these various information gaps, for 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 we need not only a one-shot collection of these data but the creation of a mechanism which will make available on a continuing basis a flow of needed information. I would expect 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.

Aside from the gathering and compilation of the necessary data, I visualize the proposed study as focusing primary attention in three or four areas which 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.

Turning now to institutional impact on the stock market, one aspect of the matter is reasonably clear. 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 intervenes as 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, it was the expectation and the experience 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. Institutionalization has thrown a very considerable strain on this mechanism.

Since institutions tend to buy or sell in fairly large quantities, the number of large bloc transactions has been increasing by leaps and bounds; for example, on the New York Stock Exchange, transactions in blocs of over 10,000 shares have tripled since 1964. In the third quarter of last year there were 1,735 transactions on the Exchange involving such blocs of 10,000 or more shares as compared to 900 such transactions in the third quarter of 1966. Further, 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 either generally or for individual securities bounce erratically up and down 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 will, accordingly, have to study the ways and means

by which the exchanges and, for that matter, the over-the-counter market can better adjust themselves and their mechanisms to the impact of a pattern of institutional trading which appears to differ very significantly from the historic pattern of trading by individual investors.

I will not endeavor to get into the economics of institutional investment at this time, particularly as I am not an economist. I would like to say, however, that in my opinion a great deal more attention to the stock market could be paid by professional economists of high caliber than there has been, perhaps because of a lack of adequate data with which to work, and the proposed study should at least provide an important impetus in that direction.

The relationship of institutional investors to the companies in which they invest is also significant and to some degree controversial. 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. It is not always easy for an institution to dispose of a large block of stock. According to another school of thought, institutional investors, with their knowledgeable professional managers and the influence which they can exert by reason of the size of their holdings, can serve as spokesmen for stockholders generally and protectors of their interests against managements.

There is the further question of whether it is or is not 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 which does not produce results, while to others it could be viewed as providing an opportunity for exercise of economic power in ways which may be detrimental to American industry. Institutional investors, it appears, are themselves unsure and divided as to what role they can or should play as stockholders. The 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. We do not, however, know enough about why it is growing, whether it will continue to grow, and, if so, at what pace and what the consequences of this will be and what measures may be necessary to cope with them.

I would like to emphasize two things about this study, particularly as some apprehension was at one time expressed with respect to them. In the first place, we intend this to be a dispassionate study that will examine basic economic phenomena. Its sole object is to find the facts and to arrive at reasoned judgments. We are not looking for male factors or seeking enforcement cases or trying to prove some point. In the second place, 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 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, as I pointed out in the letter dated February 14 to Mr. Robert W. Haack, president of the New York Stock Exchange. Chairman Sparkman inserted that letter in the Congressional Record on April 18, 1968, when he introduced Senate Joint Resolution 160.

In closing I will repeat that this resolution proposes an economic study which is very important and, in my view, necessary to the continuing 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 I am sure we will also have the cooperation and support of institutional investors themselves. We hope, therefore, that this study can get under way as soon as possible and we warmly support Senate Joint Resolution 160.

TABLE 1.—STOCKHOLDINGS OF FINANCIAL INSTITUTIONS AND OTHERS

[In billions of dollars]

	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 <sup>2</sup> .....	9.5	18.9	19.9	18.1	22.5
10. All others <sup>3</sup> (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

<sup>1</sup> Estimated market values of preferred and common stock. Excludes investment company shares but includes foreign issues outstanding in the United States.

<sup>2</sup> Includes estimate of stock held as direct investment.

<sup>3</sup> Includes individuals, personal trust funds, and nonprofit institutions.

Note: Figures may not add to totals because of rounding.

TABLE 2.—COMMON STOCK TRANSACTIONS

	[Dollar amounts in millions]				
	1957	1966	1967	Average annual percent change <sup>1</sup>	
				1957-66	1966-67
<b>1. Private noninsured pension funds:</b>					
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 <sup>2</sup> .....	\$6,638	\$38,339	\$44,128	21.5	15.1
Turnover ratio <sup>3</sup> .....	3.8	7.8	11.5	-----	-----
<b>2. Open end investment companies:</b>					
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 <sup>2</sup> .....	\$7,145	\$29,353	\$33,430	17.0	13.9
Turnover ratio <sup>3</sup> .....	13.9	30.8	38.7	-----	-----
<b>3. Life insurance companies:</b>					
Purchases.....	\$247	\$1,102	\$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 <sup>2</sup> .....	\$1,891	\$6,034	\$6,951	13.8	15.2
Turnover ratio <sup>3</sup> .....	10.7	13.7	12.8	-----	-----
	1962	1966	1967	1962-66	1966-67
<b>4. Property and casualty insurance companies:</b>					
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 <sup>2</sup> .....	\$8,102	\$10,354	\$11,018	6.4	6.2
Turnover ratio <sup>3</sup> .....	5.9	5.8	7.0	-----	-----

<sup>1</sup> For 1957-66, the percent change represents the average annual compound rate of change.

<sup>2</sup> Average of the beginning and end of the year market values.

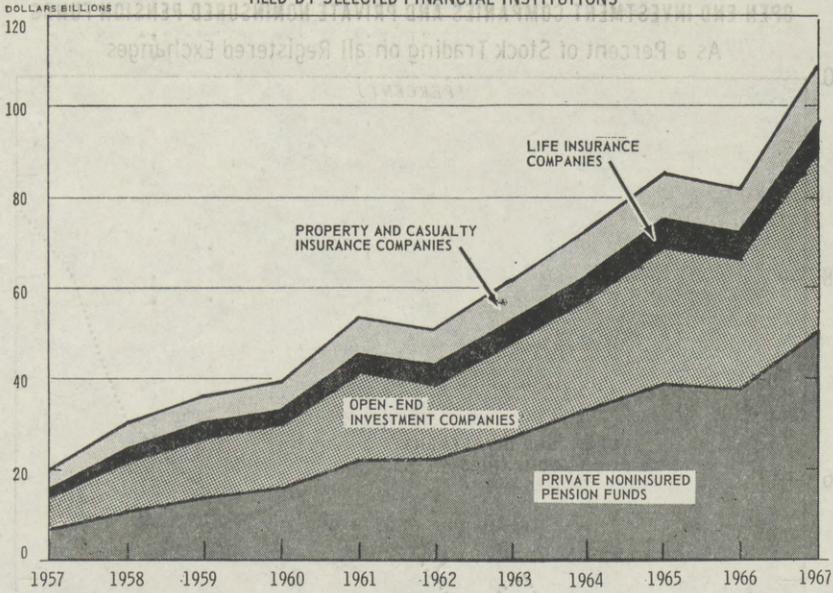
<sup>3</sup> Turnover rates are computed as the lesser of purchases or sales divided by the average of the market value of stockholdings at the beginning and end of the period.

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

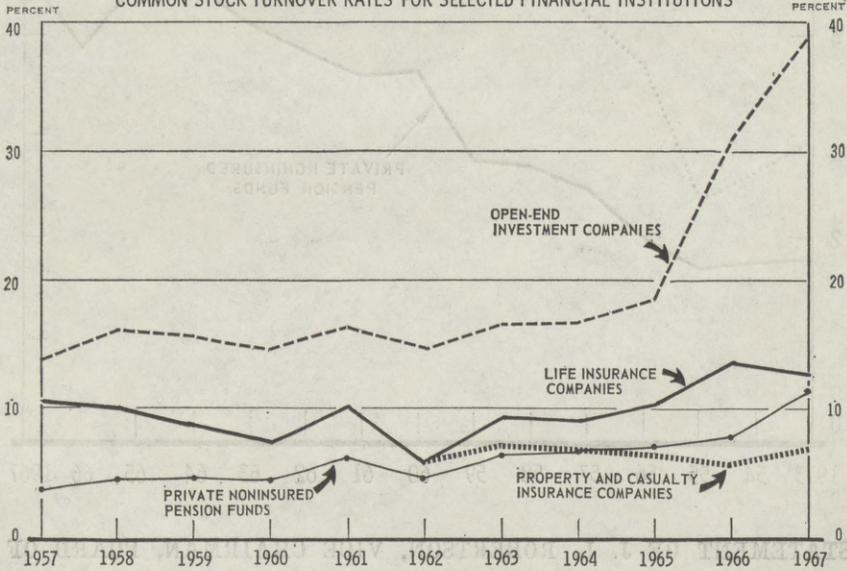
	Portfolio turnover rate <sup>1</sup> (in percent)	Number of funds	Assets (millions)
No transactions.....	-----	20	\$602.6
Sales only.....	-----	2	94.2
<b>Purchases only:</b>			
0.1 to under 10.....	-----	27	2,637.7
10 to under 20.....	-----	21	11,660.3
20 to under 30.....	-----	20	10,128.1
30 to under 40.....	-----	18	2,454.4
40 to under 50.....	-----	8	1,580.4
50 to under 60.....	-----	11	4,124.7
60 to under 70.....	-----	7	2,280.3
70 to under 80.....	-----	6	2,124.8
80 to under 90.....	-----	8	1,143.7
90 to under 100.....	-----	2	655.3
100 and over.....	-----	10	396.3
Total.....	-----	160	39,882.9

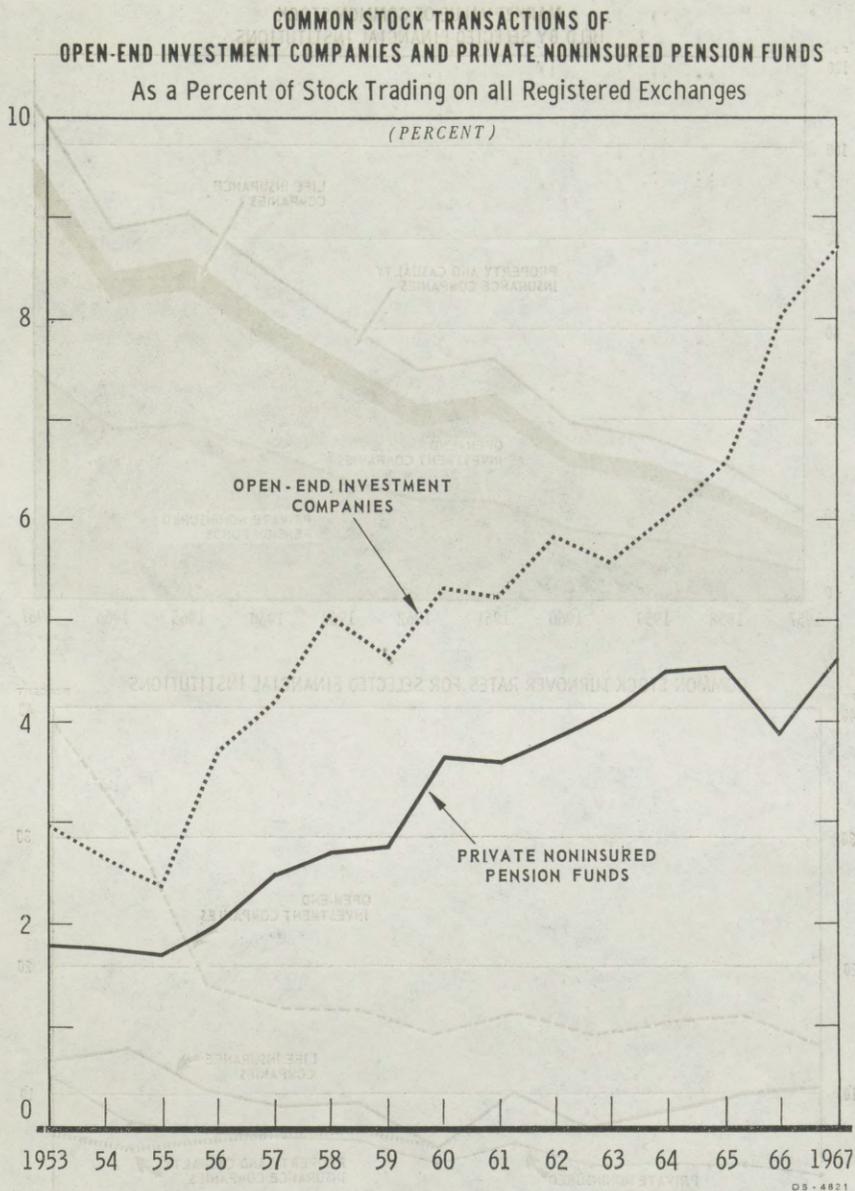
<sup>1</sup> Portfolio turnover rate is the lesser of portfolio purchases or sales as a percent of average net assets. Portfolio purchases and sales include all transactions except those in U.S. Government securities and short-term corporate securities

MARKET VALUE OF COMMON STOCK  
HELD BY SELECTED FINANCIAL INSTITUTIONS



COMMON STOCK TURNOVER RATES FOR SELECTED FINANCIAL INSTITUTIONS





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

Mr. ROBERTSON. I appear before the committee today to discuss both S. 1299—a bill to extend margin requirements to over-the-counter stocks—and Senate Joint Resolution 160, which authorizes a study of the activities of institutional investors by the Securities and Exchange Commission. I will comment on S. 1299 first.

S. 1299 was introduced at the request of the Board. It would extend the Board's authority over credit used to purchase securities registered on national securities exchanges to include those traded over the counter as well. Extension of margin requirements to the latter category would limit the amount of credit that could be obtained from banks relative to the market value of such securities. But it would not necessarily reduce the total amount of credit used to buy over-the-counter securities, since the Board would be empowered to permit brokers and dealers as well as banks to extend such credit in conformance with margin regulations. Thus the effects of regulation would tend more to improve the quality than to reduce the quantity of credit in this market.

As you know, the Board recently amended its present margin regulations and adopted a new regulation. These actions were intended to broaden the coverage of margin regulation and to close some loopholes that appeared to have developed. They 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.

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 S. 1299.

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 S. 1299 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, regardless of the purpose for which the credit is obtained. 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 S. 1299 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 70 percent. This means in effect that anyone buying a \$100 stock on credit must put up \$70 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 \$30. 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 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 \$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 has become virtually indistinguishable from that 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.

Not only do the preconditions exist for the greater use of security credit, but increasing investor interest and rising share prices in the over-the-counter markets suggest an environment in which oversue of credit could have seriously destabilizing consequences. From 1960 to 1967, for example, an index of prices of selected industrial company stocks in the over-the-counter market more than tripled, while the Dow Jones industrial index rose less than 50 percent. This kind of price action in a market that is notoriously volatile certainly suggests the need for enforcing relatively conservative standards in the extension of "purpose" credit.

#### BOARD ACTION IF S. 1299 IS ADOPTED

S. 1299 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.

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.

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 1,200 to 1,500 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 of interest, especially when a firm both positions a security and extends credit on it to his 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 S. 1299—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.

#### SENATE JOINT RESOLUTION 160

The Federal Reserve Board also recommends enactment of Senate Joint Resolution 160. This resolution would authorize a 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.

STATEMENT OF ROBERT W. HAACK, PRESIDENT OF THE NEW YORK STOCK EXCHANGE; ACCOMPANIED BY JAMES W. WALKER, JR., SENIOR VICE PRESIDENT, AMERICAN STOCK EXCHANGE; ROBERT L. AUGENBLICK, PRESIDENT, INVESTMENT COMPANY INSTITUTE; LEON P. KENDALL, PRESIDENT, ASSOCIATION OF STOCK EXCHANGE FIRMS, ON S. 1299

Mr. HAACK. My name is Robert W. Haack and I am president of the New York Stock Exchange.

The organizations which are represented here—the New York Stock Exchange, the American Stock Exchange, the Association of Stock Exchange Firms and the Investment Company Institute are pleased to endorse S. 1299.

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 brokers 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. S. 1299 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 Chairman 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 margin 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 S. 1299 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 "blue chip" 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 easily obtain accurate and timely information concerning these companies. Presently, the National Association of Securities Dealers supplies 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 8-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 marketmakers 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 S. 1299 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 suggestion 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 conflicts of interest. We are strongly opposed to that suggestion because in our view the public customers of these broker-dealers should be permitted to use the same credit facilities as customers of broker-dealers which do not make markets in unlisted securities. Further, such a restriction would thwart the basic purpose of this legislation

as the firms that are most active in the OTC market would be restricted from extending credit. These marketmakers would have to, in effect, choose between making a market or extending credit. The forcing of such a choice could be inimical to the interests of investors.

There is one further point which should be mentioned. Although S. 1299 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 rulemaking 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 is "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 S. 1299.

**STATEMENT OF ROBERT W. HAACK, PRESIDENT OF THE NEW YORK STOCK EXCHANGE; ACCOMPANIED BY JAMES W. WALKER, JR., SENIOR VICE PRESIDENT, AMERICAN STOCK EXCHANGE; ROBERT L. AUGENBLICK, PRESIDENT, INVESTMENT COMPANY INSTITUTE; LEON P. KENDALL, PRESIDENT, ASSOCIATION OF STOCK EXCHANGE FIRMS, ON SENATE JOINT RESOLUTION 160**

MR. HAACK. The organizations which are represented here today—the New York Stock Exchange, the American Stock Exchange, the Association of Stock Exchange Firms, the Investment Company Institute, and the National Association of Securities Dealers—support Senate Joint Resolution 160 which authorizes a study of institutional activity in the securities markets. The Investment Bankers Association of America also joins in this statement.

In brief, the opinion of each of these organizations is that there is a need for an institutional study, that the Securities and Exchange Commission is the proper organization to conduct the study, and that 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 my letter of March 12, 1968, to Chairman John Sparkman. 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 selfregulatory 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."

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.

For these reasons, we endorse Senate Joint Resolution 160 and urge that it be passed.

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

The letters referred to follow:

NEW YORK STOCK EXCHANGE,  
New York, N.Y., March 12, 1968.

HON. JOHN SPARKMAN,  
Chairman, Committee on Banking and Currency,  
Washington, D.C.

DEAR SENATOR SPARKMAN: 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 Banking and Currency or if I can be of service to you in any other way.

Sincerely,

ROBERT W. HAACK.

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 the 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.*

**STATEMENT OF RICHARD B. WALBERT ON BEHALF OF THE  
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., ON  
S. 1299**

Mr. WALBERT. I am Richard B. Walbert, president of the National Association of Securities Dealers, Inc. As you are aware, this association is registered with the Securities and Exchange Commission as a national securities association under section 15A of the Securities Exchange Act of 1934. It is comprised of some 3,700 members who engage in over-the-counter, nonexchange-listed securities transactions. Accordingly, S. 1299 is of great import to our members.

We support the general intention of the bill to authorize the marginability of certain over-the-counter securities under regulations to be established by the Federal Reserve Board. We are concerned, however, because of the vast number of over-the-counter securities which are outstanding, that certain implications of the bill may not be fully understood, and we wish to point out our concerns in these areas.

The first area of concern is related to the effect of the bill on broker/dealers who primarily engage in over-the-counter transactions. It should be clear that we do not anticipate a great movement by such firms, which generally are smaller-type firms, into establishment of margin accounts for customers. This is because the establishment of margin facilities is expensive, requiring more complex recordkeeping both as to initial and maintenance margin requirements and because we have had little demand by our members for authority to enter the margin area.

In addition there is no reason to believe that activity in securities which may qualify for margin will significantly increase because of the limited number of issues which will qualify. Our figures indicate that if one of the requirements is that 10 or more marketmakers be required as a qualification, then only 103 of some 1,350 securities on our national list would qualify. Should the number of marketmakers be reduced to six, then some 270 issues would qualify. Since it is estimated that more than 25,000 securities are traded over-the-counter it is apparent that any list to be established will be limited. While it is true that the advent of an automated quotations system which we are not attempting to implement may result in the availability of instant market information as to a great number of over-the-counter securities, we do not foresee the first operation of such a system until 1970.

Problems are also presented in respect to the regulatory aspects of securities which may qualify. For instance, to what extent should consideration be given to withdrawal of securities from any list which establishes securities eligible for margin in the event circumstances indicate that such is necessary? What criteria should be adopted as to securities which may be withdrawn and which would then be qualified for unregulated collateral for bank lending?

An additional concern relates to the repercussions of establishing two classes of over-the-counter securities; that is, those available for margin and those not. We foresee problems and confusion in the minds of public customers as well as the companies involved. For instance, although a small company may be of a financial stature considerably more stable than a company which qualifies for a margin by reason of its listing, the very fact that it is not qualified for margin may raise doubts in the mind of the general public and perhaps also in the minds of the company's managers. While it is true that bank credit may now be extended in unrestricted amounts on over-the-counter securities, subject only to the lending policies of the bank, it is of greatest importance that this continue to be the case. We understand that the Federal Reserve Board will continue its present policy of permitting banks to extend credit on over-the-counter securities within the discretion and dictates of their own lending policies.

Another area of concern to us is the possibility that dealers who would maintain inventories and make markets in marginable over-the-counter securities would be restricted in their ability to extend credit in respect to such securities. We believe the imposition of such a restriction to be unwarranted since standards for qualification will dissipate any potential problem in this area.

Finally, our support of the bill is with the understanding that regulations which may be issued by the Federal Reserve Board contain a provision allowing marketmakers in over-the-counter securities which would qualify for margin to continue to borrow from banks to finance their inventories, such as is the situation presently as to specialists on exchanges.

We appreciate the opportunity to appear before this committee and stand ready to cooperate with the Federal Reserve Board and the Securities and Exchange Commission in formulating regulations respecting margin qualifications for over-the-counter securities.



## APPENDIX

### ANSWERS TO QUESTIONS SUBMITTED TO THE SECURITIES AND EXCHANGE COMMISSION

RE S. 1299

*Question 1.* In your opinion, should a broker-dealer be allowed to extend margin on securities where he is making the primary market? Do you feel that there are potential conflicts of interest in such activities?

*Answer:* 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.

*Question 2.* Could you give the Committee a general statement as to the criteria such as the number of shareholders, the liquidity of the market and company earnings which should be set forth before margin should be extended on an unlisted security?

*Answer:* The preconditions generally desirable to the extension of credit on securities are depth and liquidity of the market, availability of regular and reliable quotations and availability of reliable financial information.

Section 12 of the Exchange Act, as amended by the 1964 Securities Acts Amendments, makes available certain financial information on issuers (including banks and insurance companies) whose securities are traded over-the-counter. However, the Section 12 category includes many companies whose securities have little dealer or public interest or which otherwise are unsuitable for margin credit and, therefore, other criteria should be considered to narrow this category.

The fundamental indicators of the depth and liquidity of the market for a security are volume statistics and dealer interest. In the absence of a central market place and, therefore, centralized recordkeeping facilities, presently there are no reliable statistics as to the volume of trading in the over-the-counter markets. In this connection, the anticipated development of automated quotation systems for over-the-counter securities should provide substantial information on volume as well as more current and reliable quotations.

To help assure that there is sufficient dealer interest and therefore sufficient market depth in a particular security, a criterion for margin eligibility could require a minimum number of independent competitive marketmakers over a period of time. Other indicators of depth and liquidity of the market are the number of stockholders of a security, the number of shares outstanding, and the public distribution of the shares. Furthermore, minimum standards as to net assets and net earnings, such as exist for listing on the major exchanges, may also deserve consideration in order to ensure a category of issuers with adequate financial stability.

*Question 3.* Section 11(d) of the Securities Exchange Act prohibits the extension of credit by broker-dealers on the purchase of new issues. Since mutual fund shares which are in continual registration come under Section 11(d), do you feel that it would be appropriate for mutual fund shares to be exempt from this prohibition?

*Answer.* 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.

RE SENATE JOINT RESOLUTION 160

*Question 1.* Recently, there have been cases of mutual funds buying corporate stock as part of an effort to change company management through proxy fights. In other cases, stock owned by mutual funds has been decisive as to which side would win proxy fights. Do you think that there should be statutory controls concerning the voting of portfolio company shares in proxy fights by mutual funds or other institutional investors?

*Answer.* This problem has been somewhat controversial. As mentioned on page 9 of my prepared statement to the Committee, some believe that mutual funds and other financial institutions, since they are informed, professional and influential investors can play a useful role in representing and protecting the interests of stockholders in such controversies. Others feel that participation by financial institutions in such contests may lead to an excessive concentration of financial power over American industry and may afford opportunities for the misuse of such power. Institutional investors themselves appear to be somewhat uncertain as to what their rights and obligations in such a situation are.

We expect that the proposed study will explore the pros and cons of this question thoroughly as well as collecting data as to what institutional investors actually do in these situations and what the impact of this is on corporate management. Hopefully, it will then be possible to develop more general agreement as to the proper role of institutional investors in such contests and also to arrive at an informed judgment as to what legislative action, if any, is needed.

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.

*Question 2.* The short term portfolio turnover of institutional investors and mutual funds in particular has increased significantly during the past year. Do you feel that such activities have been detrimental to the orderly functioning of the securities markets? Is it possible that this trading has increased price fluctuations of listed securities?

*Answer.* Stock exchanges have proven their capacity to serve as central auction markets to which there flow orders, each relatively small, from many individual investors, with prices being determined by the forces of supply and demand. Since individual investors buy and sell on the basis of a great variety of information and for a great variety of reasons, it has been the experience that, under normal circumstance, there is a reasonable balance of buy-and-sell orders, and any temporary imbalance can be handled by specialists whose function is to participate as dealer only when necessary to provide depth and liquidity.

Institutional investors, however, and particularly mutual funds, trade in very large blocks and their turnover rate has greatly increased in the past few years. As these investors may often concentrate in the same securities and may buy or sell on the same information at times their transactions have caused imbalances which have increased price fluctuation of listed securities and placed a strain on the mechanisms of the market. While we have observed such situations, there is a need

for additional data to reach definitive conclusions as to the full effects of short term portfolio turnover. One of the purposes of the study proposed by S.J. Res. 160 is to inquire into short term trading impact.

*Question 3.* This Resolution requires the SEC to report its findings to Congress by December 31, 1969 and authorizes an appropriation of \$825,000. Would you care to comment on the feasibility of the cut-off date and the authorization?

*Answer.* First with respect to the cut-off date, if the Resolution is enacted into law quite promptly, say within a month or so, I believe that it would be possible to meet the cut-off date, although undoubtedly this would impose a tight time schedule. If, on the other hand, enactment of the Resolution is delayed, then there probably should be an adjustment in the cut-off date so as to give us not less than 18 months for the study.

With respect to the authorization, the possible scope of the study which could be made in response to the Resolution, if all of the significant questions are to be fully explored, would be quite broad and probably not feasible within the \$825,000 authorization. On the other hand, I am hopeful that we will receive the assistance and cooperation of universities, private foundations and institutional investors themselves, so that a substantial amount of data can be collected and important research done without cost to the Government. If this expectation is realized, then I would think it possible to produce a valuable result within the limitations of the proposed authorization.

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ANSWERS TO QUESTIONS SUBMITTED TO THE NEW YORK STOCK EXCHANGE

NEW YORK STOCK EXCHANGE,  
New York, N.Y., May 24, 1968.

HON. JOHN J. SPARKMAN,  
Chairman, Committee on Banking and Currency,  
New Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The Exchange's written responses to the three questions on S. 1299 and S.J. Res. 180 are enclosed. We would be pleased to attempt to answer any additional questions the members of the Committee might have on these two bills.

Had I testified at the hearings last Thursday, I would have cited some very recent statistics on the growing importance of institutional activity in our market. My reason for doing so would have been to emphasize again the need for a study of institutional activity in the securities markets because of the rapidly accelerating growth in institutional activity.

The following 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%-13.0%) 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.

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

Figures for last month, April, 1968, show that this trend is intensifying. In the one month of April, 1968, large blocks were about half of the total for the entire 1st quarter of 1968, as is shown by the following table.

Reported share volume (mils.)	296
Daily average share volume (mils.)	14.8
Large blocks	989
Shares (mils.)	25
Value (mils.)	\$1,004
Percent of reported volume	8.4

In our opinion, these recent figures emphasize the need for prompt Congressional approval of Senate Joint Resolution 160.

Sincerely,

ROBERT W. HAACK, *President.*

## RESPONSES TO WRITTEN QUESTIONS ON SENATE JOINT RESOLUTION 160

Question 1. Recently, there have been cases of mutual funds buying corporate stock as part of an effort to change company management through proxy fights. In other cases, stock owned by mutual funds has been decisive as to which side would proxy fights. Do you think that there should be statutory controls concerning the voting of portfolio company shares in proxy fights by mutual funds or other institutional investors?

Answer. Chairman Cohen, in his testimony (see page 6 of his statement on Senate Joint Resolution 160), specifically mentioned that one of the primary areas to be studied would be "the proper role of a financial institution as a stockholder." As of the present time, there is very little information available on the role institutions have played and do play in proxy contests. Until the study authorized by S.J. Res. 160 produces some meaningful information on the role of institutions as stockholders, it would, in our opinion, be premature to discuss the need for or the nature of statutory controls in this area.

Question 2. The short term portfolio turnover of institutional investors and mutual funds in particular has increased significantly during the past year. Do you feel that such activities have been detrimental to the orderly functioning of our securities markets. Is it possible that this trading has increased price fluctuations of listed securities?

Answer. 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 has been detrimental to the orderly functioning of the securities markets would undoubtedly be a major area to be covered by the proposed study envisioned by S.J. Res. 160. 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 following report, prepared 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 the 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.

## INFLUENCE OF INSTITUTIONAL INVESTORS ON STOCK PRICE STABILITY

(Based on two statistical studies)

## 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 decri 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 $\pm\frac{1}{4}$ point.....	96	45.9
$\pm\frac{1}{8}$ to $\frac{1}{2}$ .....	38	18.2
$\pm\frac{3}{8}$ to $\frac{3}{4}$ .....	24	11.5
$\pm 1$ 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.<sup>1</sup>

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.

<sup>1</sup> 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.

### 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.

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, 3D 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 one 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	0.9
New product(s).....	19	1.5
Other.....	35	2.8
Investment advisory service recommendation.....	5	0.4
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 investigator 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 any 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.

Question 3. This Resolution requires the SEC to report its findings to Congress by December 31, 1969, and authorizes an appropriation of \$825,000.

Would you care to comment on the feasibility of the cut-off date and the authorization?

Answer. As regarding the feasibility of the cut-off date and amount of the authorization in S.J. Res. 160, the Exchange defers to the judgment of the SEC.

Inasmuch as the Resolution must still proceed through Congress to enactment, one possibility that might be entertained would be for the cut-off date to be 18 months after the effective date of the Resolution.

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RESPONSES TO WRITTEN QUESTIONS ON S. 1299

Question 1. In your opinion, should a broker-dealer be allowed to extend margin on securities where he is making the primary market?

Do you feel that there are potential conflicts of interest in such activities?

Answer. On page 5 of the statement which we filed with the Committee, we voiced our strong opposition to the suggestion that market makers not be permitted to extend credit on the OTC securities in which they make a market. As we stated, 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 and Exchange Act of 1934 give the SEC ample authority to deal with the situation.

Question 2. Could you give the Committee a general statement as to the criteria such as the number of shareholders, the liquidity of the market and company earnings which should be set forth before margin should be extended on an unlisted security?

Answer. We are in general agreement with the approach the Federal Reserve Board indicates in its statement to the Committee 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 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 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 pre-requisites 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.

Question 3. Section 11(d) of the Securities Exchange Act prohibits the extension of credit by broker-dealers on the purchase of new issues. Since mutual fund shares which are in continual registration come under Section 11(d), do you feel that it would be appropriate for mutual fund shares to be exempt from this prohibition?

Answer. We answered this question on pages 5 and 6 of our statement by stating that "there is no reason to distinguish mutual fund shares from other unlisted securities for purposes of this bill."

THE AMERICAN BANKERS ASSOCIATION,  
Washington, D.C., May 15, 1968.

Hon. JOHN J. SPARKMAN,  
Chairman, Senate Committee on Banking and Currency,  
Washington, D.C.

DEAR MR. CHAIRMAN: This letter is written to express the views of The American Bankers Association with respect to S. 1299, a bill introduced by request of the Federal Reserve Board proposing certain amendments to the Securities Exchange Act of 1934.

At the present time, loans extended by commercial banks for the purchase of over-the-counter securities are permitted without regard to the margin requirements established by the Federal Reserve Board for securities listed on national or regional securities exchanges. Also, existing law prohibits broker-dealers from making loans on unlisted securities on any terms. The amendments proposed by S. 1299 would permit the Federal Reserve Board to apply the same margin requirements required for exchange-listed stocks to an administratively designated group of unlisted securities used as collateral for loans from both banks and broker-dealers.

At the time the Securities Exchange Act was adopted, unlisted securities were not included for margin requirement purposes, because, among other reasons, unlisted securities represented a minimal percentage of the total securities trading volume. However, in the intervening years, trading activity in over-the-counter securities has increased substantially. A study conducted by the Securities Exchange Commission reflected that in 1962 approximately one-third of all bank credit secured by stocks was collateralized by stocks not listed on national or regional exchanges. Additionally, this study indicated that of the total amount of bank loans made for the purpose of purchasing or carrying stocks approximately 50 percent was related to unlisted securities. These facts alone would seem to justify enlarging the scope of credit regulation by the Federal Reserve Board to include a selective portion of the securities actively traded outside the national and regional exchanges. There does not seem to be any valid justification for differentiating between exchange-listed securities and unlisted securities, which are actively traded in the application of selective credit controls. In fact the effectiveness of the existing credit regulation applied to listed securities may be diluted by the present lack of authority to restrict credit extensions for certain over-the-counter securities. On balance The American Bankers Association believes that the purposes and objective of the proposed legislation are justified, and we support enactment of S. 1299.

We do note that the Federal Reserve Board has indicated in its communications with reference to the proposed legislation that it has no intention of extending margin requirements to all unlisted securities. We understand that it is the Board's present intention to apply margin requirements only to those unlisted securities which are subject to the public disclosure requirements of the Securities Exchange Act and which are traded in sufficient volume to assure reliable pricing, reasonable liquidity, and substantial investor and dealer interest. None of these criteria are presently included in the proposed amendments. We recognize that it may be impractical to include any rigid statutory standards governing the Board's exercise of this new margin requirement authority. Nevertheless, we do believe that it would be useful to include certain specified criteria in the Committee report as a part of the total legislative history to provide general guidelines for the future action of the Federal Reserve Board in this area.

We hope that our views as expressed in this letter may be made a part of the hearing record of the Senate Banking and Currency Committee on S. 1299.

Sincerely,

CHARLES R. McNEILL,  
Director, Washington Office.

AMERICAN LIFE CONVENTION, AND  
LIFE INSURANCE ASSOCIATION OF AMERICA,  
May 14, 1968.

Hon. JOHN J. SPARKMAN,  
U.S. Senate, Washington, D.C.

DEAR SENATOR SPARKMAN: 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 352 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 the Joint Resolution (S.J. Res. 160) introduced by you on April 18, 1968, 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 constitute 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,

WILLIAM B. HARMAN, Jr.,  
General Counsel.

KENNETH L. KIMBLE,  
Vice President and General Counsel.

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MIDWEST STOCK EXCHANGE,  
Chicago, Ill., May 13, 1968.

Hon. JOHN SPARKMAN,  
Senate Banking and Currency Committee,  
U.S. Senate,  
New Senate Office Building, Washington, D.C.

MY DEAR SENATOR SPARKMAN: The Midwest Stock Exchange wishes to go on record in support of Senate Joint Resolution 160 which would authorize the Securities and Exchange Commission to make a study of institutional investors and the effect of their sales and purchases on the Nation's securities markets.

You will, no doubt, recall that it was the late James E. Day who first proposed a broad institutional study during testimony before your Committee on the Mutual Fund Bill. Our Exchange feels as strongly in favor of this study now as we did when the idea was introduced, but we would emphasize the need to have the study laid out and coordinated in such a way as to produce maximum cooperation from those who could logically make a contribution, and directed in such a way as to accommodate the broadest possible viewpoint.

Our Exchange is desirous of cooperating with this study and in playing an active role. My letter to Chairman Manual F. Cohen, May 3, 1968, speaks to this point and a copy is enclosed for your information. If there is anything that our Exchange could do to further the accomplishment of the study, you have our unqualified commitment for cooperation.

Very truly yours,

MICHAEL E. TOBIN, *President.*

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MIDWEST STOCK EXCHANGE,  
Chicago, Ill., May 3, 1968.

MANUEL F. COHEN,  
Chairman, Securities and Exchange Commission, North Capitol Street, Washington,  
D.C.

DEAR CHAIRMAN COHEN: It was particularly gratifying to this Exchange when, on April 18, Senator John Sparkman filed a Senate joint resolution authorizing a study of the impact of institutional investors on the Market.

As you will recall, it was the late James E. Day who first proposed an institutional study in testimony before the Senate Banking and Currency Committee during hearings in the Mutual Fund Bill.

Correspondence involving Senator Sparkman, Mr. Robert W. Haack and yourself which was printed in the Congressional Record, parts of which you had already forwarded directly to us, gives an outline as to the objectives of the study and how it would be conducted.

However, we have a specific concern that was not spoken to on the record thus far and that is the ability of our Exchange to be represented not only in the original meeting that is considered the first step in the preparation of the study, but also our ability to remain a continuing voice in the study by being represented on the advisory committee.

We feel very strongly that Midwest represents a unique point of view which will be very pertinent to the study together with the awareness of the problems as is evidenced by our recommendation of the study. Therefore, we would like your thinking regarding the inclusion of a representative from Midwest not only in the original conference, but as a permanent member of the advisory committee.

Very truly yours,

MICHAEL E. TOBIN, *President.*

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INVESTMENT BANKERS ASSOCIATION OF AMERICA,  
*Washington, D.C., May 15, 1968.*

HON. JOHN SPARKMAN,  
*Chairman, Senate Committee on Banking and Currency,  
New Senate Office Building,  
Washington, D.C.*

DEAR SENATOR SPARKMAN: SEC Chairman Cohen in his letter of February 14, 1968 to the President of the New York Stock Exchange explained in some detail the purpose of the proposed study of the impact of institutional investors in the securities market and the steps which would be taken in the preparation of the study.

Chairman Cohen made it clear that the study is to be an economic study, not an investigation, and that it is intended to produce information concerning basic economic trends that will be helpful to everyone concerned with the role of institutions in the securities markets. Chairman Cohen also stated that he contemplated the creation of an Advisory Committee representative of the various interests concerned, which would meet regularly with the study staff and with the Commission and that it would have an active role in shaping the scope and conduct of the study.

The Investment Bankers Association of America believes that a study of the impact of institutional investors in the securities market, as proposed in S. J. Res. 160 and conducted for the purpose and under the procedures outlined in Chairman Choen's letter, would be constructive and would provide needed information. Accordingly, we endorse Senate Joint Resolution 160 and urge that it be adopted.

We thought that it would save the time of your Committee simply to submit this statement rather than to have a witness testify at the hearing on May 16th. Therefore, we respectfully request that this letter be included in the printed record of the hearing.

We are mailing to you under separate cover for your information indicative of the interest of our Association in studies of the securities markets, a copy of the summary volume of "Investment Banking and the New Issues Market," prepared by the Securities Research Unit at the Wharton School of Finance and Commerce in 1965 under a grant from the Investment Bankers Association.

Respectfully,

GORDON L. CALVERT.

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GENERAL COUNSEL OF THE DEPARTMENT OF COMMERCE,  
*Washington, D.C., June 3, 1968.*

HON. JOHN SPARKMAN,  
*Chairman, Committee on Banking and Currency,  
U.S. Senate, Washington, D.C.*

DEAR MR. CHAIRMAN: This is in further reply to your request for the views of this Department with respect to S. 1299, 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.

Under the Securities Exchange Act of 1934, the Federal Reserve Board may prescribe rules and regulations with respect to the amount of credit that may be

extended and maintained on securities registered on a national securities exchange. In determining its rules, the Federal Reserve Board seeks to accommodate the needs of commerce and industry and the general credit situation of the economy, while avoiding excessive use of credit to finance transactions in securities. The Act makes the Federal Reserve Board regulations governing the extension of credit on a national securities exchange binding on members of the exchange, brokers, dealers, and banks. The Act prohibits brokers and dealers from extending credit on securities not on a national securities exchange, but traded Over-the-Counter (OTC). Banks are not subject to a like restriction on extending credit on OTC securities.

S. 1299 would authorize the Federal Reserve Board to establish credit controls with respect to securities traded on the OTC market and would permit brokers and dealers for the first time to extend credit on OTC securities subject to the credit limitations imposed by the Federal Reserve Board. Banks which extend credit on OTC securities would also be subject to these credit controls.

The Department of Commerce supports the enactment of S. 1299.

S. 1299 would permit the Federal Reserve Board to impose the same credit controls, which govern transactions in securities listed on the national securities exchanges, upon OTC securities. The proposed extension of credit control by the Federal Reserve Board with respect to OTC securities should increase the effectiveness of the Board in carrying out its statutory responsibility with respect to the Nation's overall supply of money and credit.

By permitting brokers and dealers to extend credit on OTC securities, the bill would eliminate the existing inequity which allows banks but not brokers and dealers to extend credit on OTC securities.

We have been advised by the Bureau of the Budget that there would be no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

JOSEPH W. BARTLETT, *General Counsel.*

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#### INVESTMENT COMPANY INSTITUTE RESPONSES TO WRITTEN QUESTIONS

*Question 1: Recently, there have been cases of mutual funds buying corporate stocks as part of an effort to change company management through proxy fights. In other cases, stock owned by mutual funds has been decisive as to which side would win proxy fights. Do you think that there should be statutory controls concerning the voting of portfolio company shares in proxy fights by mutual funds or other institutional investors?*

Answer: Based upon information presently available, we see no reason for statutory controls concerning the voting by mutual funds or other institutional investors of portfolio company shares in proxy fights. It would be unfortunate to attempt to impose any such statutory restrictions on fund managements which would deny them the voting rights accorded to all other stockholders.

When an institutional investor purchases the stock of a portfolio company it is fair to assume that this is done only after very careful study of the company and an assessment of its potential as a profitable investment. In the event that a proxy fight should develop, the institutional investor is under a duty to the persons it represents to satisfy itself that its continued investment in the portfolio company is desirable and then to vote its shares in support of a slate which in its considered opinion is most beneficial to the portfolio company. Such a vote would also serve the best interests of the less sophisticated shareholder of the portfolio company.

We also point out that as a matter of law mutual funds are required to state in their registration statements filed with the SEC their policy with respect to investing for purposes of control. This requirement is found in Form N-8B-1 Item 5(d) promulgated by the Commission pursuant to the Investment Company Act of 1940, which requires a statement with respect to the mutual fund's policy of investment "for the purpose of exercising control or management". Almost all mutual fund members of the Institute have stated investment policies which specifically negate any intent to exercise control or management over portfolio companies. If a mutual fund should act in concert with any affiliated third party to acquire control of a portfolio company, an application must first be made to the SEC for an order under Rule 17(d)-1 of the 1940 Act permitting such joint action—see, for example, the recent opinion of the Securities and Exchange Com-

mission in *The Matter of Talley Industries, Inc.* (Investment Company Act Release No. 5358). Thus, the Securities and Exchange Commission is presently charged with the responsibility of protecting the public interest in the event that there should develop concerted action between the mutual fund and a related third party for the purpose of control of a portfolio company.

Finally, we have supported pending Senate Joint Resolution 160 which provides for a study under the direction of the SEC of institutional activity in the securities markets. This study will undoubtedly encompass the question of institutional control and influence on portfolio companies. As Chairman Cohen of the SEC pointed out in his testimony some observers hold the view that institutional investors should concern themselves with management policies of portfolio companies while others feel that institutions should not concern themselves with such matters, except to sell if they are in disagreement with the policies of management. The factual data and conclusions of the study should be helpful in determining whether a problem, if any, exists in this area.

*Question 2: The short term portfolio turnover of institutional investors and mutual funds in particular has increased significantly during the past year. Do you feel that such activities have been detrimental to the orderly functioning of our securities markets?*

*Is it possible that this trading has increased price fluctuation of listed securities?*

Answer: So far as we know, there is insufficient economic data available at this time to provide an answer to this question. The answer should be provided by the results of the study of institutional activity in the securities markets which is authorized by Senate Joint Resolution 160. It might be noted that available data for prior periods indicate that portfolio activity of mutual funds has had a stabilizing effect on the securities markets. In 10 significant periods of market decline between 1946 and 1966 for which such data exist mutual funds were net purchasers and thus had a beneficial effect on the market. See, Hearings, Committee on Banking and Currency, 90th Congress, First Session, on S. 1659, Part I, page 323.

*Question 3: Section 11(d) of the Securities Exchange Act prohibits the extension of credit by broker-dealers on the purchase of new issues. Since mutual fund shares which are in continual registration come under Section 11(d), do you feel that it would be appropriate for mutual fund shares to be exempt from this prohibition?*

Answer: This question points to a matter which was briefly covered in the testimony of Robert Haack, President of the New York Stock Exchange, on S. 1299. Mr. Haack pointed out that Section 11(d)(1) of the Securities Exchange Act of 1934 might be interpreted to bar the Federal Reserve Board from utilizing rule-making power granted to the Board under S. 1299 in connection with the extension of credit by broker-dealers on mutual fund shares. Although we believe that S. 1299, as written is broad enough to permit the Board to exercise appropriate discretion it is desirable to remove any ambiguity caused by certain language contained in Section 11(d)(1).

Section 11(d)(1) makes it unlawful for a person who acts as both a broker and a dealer to directly or indirectly extend, maintain, or arrange "for the extension or maintenance of credit to or for a customer on any security . . . which was a part of a new issue" until 30 days after the broker-dealer ended his participation in the distribution.

Section 11(d)(1) is one part of a section of the Exchange Act which was designed to deal with various conflicts of interest between those in the brokerage business who act as a broker and a dealer. It is for this reason that the prohibition in Section 11(d)(1) is restricted to those who act as both a broker and a dealer. The legislative history shows the particular conflicts of interest which concerned the Congress. As stated in the House Committee Report:

"It is difficult to serve two masters. And it is particularly difficult to give impartial advice to a client if the dealer-broker has his own securities to sell, particularly when they are new securities for which there is no ready market . . . [Section 11(b)(1)] strikes at one of the greatest potential evils inherent in the combination of the broker and dealer function in the same person, by assuring that he will not induce his customers to buy on credit securities which he has undertaken to distribute to the public." (House of Representatives Report No. 1383, 73rd Congress, Second Session, on H.R. 9323, Securities and Exchange Bill of 1934, pp. 15, 22.)

Whatever the merit of the policies underlying Section 11(d)(1) in the context of modern regulatory controls, it is apparent that they do not apply to mutual

funds. Mutual fund shares are not distributed on a guaranteed basis at a fixed price as in the case of the classical underwriting contemplated by Section 11(d) (1). Neither mutual fund underwriters nor dealers make any commitment to place any particular amount of fund shares and, moreover, they have not guaranteed the fund any particular price.

Except as a matter of semantics in the use of the phrase "new issue", Section 11(d) (1) has no applicability to mutual funds. Mutual fund shares are only considered part of "new" issues because those funds which offer shares to the public are in continuous registration under the provisions of the Securities Act of 1933 and the Investment Company Act of 1940. This is for the purpose of making certain that each investor receives a current prospectus which makes adequate disclosures. However, because of this, each share sold by a dealer may technically be viewed as "part of a new issue" and thus within the purview of Section 11(d) (1). In view of the background of Section 11(d) (1) and the meaning of the term "new issue" in the proper context, it would be inappropriate to interpret this section to include mutual funds.

As indicated above, not only do mutual funds fall outside of the policies underlying Section 11(d) (1) but fund shares uniquely qualify under the criteria which the Federal Reserve Board advanced during the hearings for consideration in connection with credit extension on over-the-counter securities. Vice-Chairman Robertson of the Board of Governors of the Federal Reserve System noted that Section 7 of the Securities Exchange Act of 1934, which would be amended by S. 1299, treated listed and unlisted securities differently for credit purposes for a number of reasons. He pointed out that in 1934 there was little information available to investors about over-the-counter issues. However, under the 1964 Securities Acts Amendments a number of over-the-counter issuers now disclose information to the public in much the same fashion as companies whose securities are listed on exchanges. With respect to disclosure, mutual funds certainly provide adequate information to investors. Under the federal securities laws more information is probably available about mutual funds than any other kind of security.

Other changes with respect to over-the-counter securities through the years which were analyzed in the testimony of Vice-Chairman Robertson also lead to the conclusion that mutual fund shares are appropriate to be considered for extension of credit. Mr. Robertson noted that the reliability of over-the-counter quotations has substantially improved between 1934 and the present, and that over-the-counter issues were less volatile today than in the past. The pricing mechanism used by mutual funds assures investors of adequate price information; quotations are widely published in the newspapers and are readily available to investors and credit institutions. The diversification of mutual fund portfolios and the professional management of fund portfolios assures that the mutual funds are, on the average, less volatile than individual securities listed or unlisted. Thus, mutual funds easily meet the criteria advanced in support of S. 1299.

We believe that it would be inappropriate under these circumstances to withdraw from the Federal Reserve Board the discretion to determine whether and to what extent broker-dealers may properly extend credit on mutual funds when at the same time such discretion is given to the Federal Reserve Board as to all other over-the-counter securities.

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NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,  
Washington, D.C., May 29, 1968.

HON. JOHN J. SPARKMAN,  
*Chairman, Committee on Banking and Currency,  
U.S. Senate, New Senate Office Building, Washington, D.C.*

DEAR SENATOR SPARKMAN: This is in response to the written questions submitted to us by your Committee on May 16 in respect to the above mentioned bills. We are in agreement with the views expressed by the New York Stock Exchange in its letter to you of May 24, 1968 as to Senate Joint Resolution 160, and thus will answer only those questions relating to S. 1299.

QUESTION NO. 1

Our views on this subject are expressed in our written statement submitted to the Committee on May 16. These views, which had not come to the attention of the Committee at the time of the preparation of its inquiries to us, are essentially that competitive conditions would eliminate any conflict of interest in the event a market making broker/dealer were to extend margin credit to customers on the same securities in which it is making a market.

## QUESTION NO. 2

A general statement is requested as to criteria such as number of shareholders, liquidity and earnings which should be required before margin should be extended on an unlisted security. While we wish to be as helpful to the Committee as possible it is most difficult to set forth definitive criteria for margin qualification because of the diverse nature of the over-the-counter market. Any strict criteria would almost surely exclude a substantial number of companies which by almost any standard should fully qualify for marginability. It would appear to use that a company reporting to the Securities and Exchange Commission under the requirements of the Securities Acts Amendments of 1964, would be a minimal standard. Thereafter, we believe that exchange listing requirements, together with certain standards for publication of quotations of over-the-counter securities in the National Daily and Weekly List furnished by the NASD to the news services should be analyzed to develop the necessary qualifications to marginability. It would seem to us that when such criteria are developed, an area for the application for expert judgement in the field of securities will remain, and we would expect to be in a position to offer the services of the securities industry in this respect.

## QUESTION NO. 3

In the statement dated May 16, 1968, on behalf of the New York Stock Exchange, American Stock Exchange, and Investment Company Institute the view is expressed that there are no reasons to distinguish mutual funds from other unlisted securities for the purposes of the bill. We concur with this position and would be pleased to submit further data in answer to this question should you request it.

We appreciate your continued interest in these matters and would be pleased to elaborate upon these answers.

Very truly yours,

RICHARD B. WALBERT, *President.*

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INDEPENDENT BROKER DEALERS' TRADE ASSOCIATION,  
*Springfield, Mass., May 24, 1968.*

HON. JOHN J. SPARKMAN,  
*Chairman, Senate Banking and Currency Committee,*  
*Washington, D.C.*

DEAR SENATOR SPARKMAN: Our group wishes to associate itself with the views expressed by the New York Stock Exchange in connection with the above referred-to resolution and bill. We request that our views be made a part of the record.

We understand the Federal Reserve Board supports S. 1299, which will amend the Securities Act of 1934 to allow brokers and dealers to extend credit for the purpose of purchasing or carrying over-the-counter equity securities by clients. If enacted, the bill will eliminate the present difference in status for credit purposes of securities traded on exchanges and securities traded over the counter. We are in favor of this action.

We believe the study of institutional trading authorized in S. J. Res. 160 will be helpful, and we wish to state again that we believe the proposed Advisory Committee called for to advise the SEC can serve a useful purpose. We would hope the SEC will see fit to include a representative of our group on the Advisory Committee.

Very truly yours,

RAYMOND W. COCCHI, *President.*

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ASSOCIATION OF STOCK EXCHANGE FIRMS,  
*New York, N.Y., June 4, 1968.*

HON. JOHN J. SPARKMAN,  
*Chairman, Committee on Banking and Currency,*  
*New Senate Office Building, Washington, D.C.*

DEAR SENATOR SPARKMAN: This letter is in response to the written questions submitted by your Committee with respect to S. 1299, the Over-the-Counter Margin Bill, and S. J. Res. 160, the Institutional Study Proposal.

As was true in the original statements submitted to the Committee, the Association identifies itself with the replies to the Committee's questions submitted

by the New York Stock Exchange under letter dated May 24, 1968. While so doing, we wish to offer the following additional comments regarding Question 1 on S. 1299 for the guidance of the Committee :

We believe that broker-dealers should be allowed to extend margin on stocks in which they are also making markets. 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 would become highly volatile, increasing rather than decreasing the risks of manipulation and conflict of interest alluded to in the Federal Reserve Board's statement.

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 cast 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.

Thank you for the opportunity to submit these additional comments. We would be pleased to answer any further questions that you or your Committee may have.

Sincerely,

LEON T. KENDALL.



